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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 614

R. A. HOLMAN & CO., INC., *Petitioner,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

R. A. HOLMAN & CO., INC., AND RICHARD A. HOLMAN, *Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Second Circuit entered September 21, 1966, petition for rehearing granted, opinion amended, and judgments reaffirmed on May 15, 1967.

OPINIONS BELOW

On September 21, 1966, the Court of Appeals affirmed an order of the Securities and Exchange Commission revoking the registration of petitioner R. A. Holman & Co. as a broker and dealer, expelling it from membership in the National Association of Securities Dealers, Inc., and making permanent an earlier SEC order temporarily suspending the exemption from registration requirements of an offering of securities. The opinion in this case is printed in Appendix A at pp. 1a-16a, *infra,* and is reported at 366 F.2d 446 (1966).

Petitioner's petition for rehearing was granted and on May 15, 1967, the Court handed down another opinion, amending its former opinion, but re-affirming its earlier judgment. This opinion is printed in Appendix B at pp. 17a-23a, *infra,* and is reported at 377 F.2d 665 (1967).

Also on September 21, 1966, the Court of Appeals affirmed an order of the District Court for the Southern District of New York, permanently enjoining petitioners R. A. Holman & Co. and Richard A. Holman, at the suit of the SEC, from specified violations of Section 17(a) of the Securities Act of 1933 and Section 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 77q(a), 78o(c)(1). The opinion in this case is printed in Appendix C at pp. 24a-27a, *infra,* and is reported at 366 F.2d 456 (1966).

The Court denied rehearing in this case on May 15, 1967. Its denial is reported at 377 F.2d 665 (1967).

JURISDICTION

The United States Court of Appeals for the Second Circuit had jurisdiction under Section 9 of the Securities Act of 1933, 15 U.S.C. § 77i, Section 25 of the

Securities Exchange Act of 1934, 15 U.S.C. § 78y, and 28 U.S.C. § 1291. The judgments were entered on September 21, 1966, and were re-affirmed on the disposition of the petition for rehearing on May 15, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1). The time for filing a Petition for Certiorari was extended by this Court to September 13, 1967.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provision involved is the Due Process Clause of the Fifth Amendment to the Constitution of the United States.

The statutory provisions involved are: Sections 5(c), 7(a), and 11 of the Administrative Procedure Act, 5 U.S.C. §§ 1004(c), 1006(a), 1010; Sections 3(b), 8(b), 8(d), and 17(a) of the Securities Act of 1933, as amended, 15 U.S.C. §§ 77c(b), 77h(b), 77h(d), and 77q(a); and Sections 15(b) and 15(c)(1) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §§ 8o(b), 78o(c)(1). They are printed in Appendix D, p. 28a, *infra.*

QUESTIONS PRESENTED

1. Do constitutional standards of due process and the Administrative Procedure Act permit a prosecutory proceeding in an administrative agency, which can result in the destruction of a valuable going business, to be conducted by a Hearing Examiner who is appointed by the agency and whose status as Hearing Examiner is terminable at the will of the appointing agency?

2. Do constitutional standards of due process and the Administrative Procedure Act permit a member of an administrative agency to participate in an adjudicative proceeding when he has previously been a member of the agency's staff with responsibility for the investigation from which the charges in the proceeding arose?

3. When a *prima facie* showing of the disqualification of an agency member is made, may that member refuse to disclose facts relevant to the issue of his disqualification which are peculiarly and exclusively within his own knowledge?

4. May predictions of future increase in a stock price be held to be *per se* fraudulent in injunctive proceedings initiated by the SEC in the District Courts, when the same predictions could not be held fraudulent in an administrative proceeding before the SEC in the absence of a showing that the predictions were without reasonable basis in the light of such factors as the sales and earnings of the company and the market history of its shares?

STATEMENT OF THE CASE

A. Introduction

This case, as the SEC itself has stated:

> "raises a question of first impression, having government-wide implications affecting the validity of all proceedings presided over by retired Hearing Examiners who have been reemployed."

It involves the administrative expulsion of a company from the securities business in a proceeding con-

ducted by a Hearing Examiner who was totally dependent for his continued tenure and compensation on the will of the agency which appointed him.

This case also raises the issues whether an administrative official may exercise investigative, prosecutive, and then adjudicative responsibilities in the same proceeding and whether a litigant may be blocked from obtaining the facts relevant to the disqualification of that official to sit in judgment in the case.

B. The Parties and Proceedings Below

Petitioner R. A. Holman & Co. was registered with the SEC in 1958 as a broker-dealer under Section 15(b) of the Securities Exchange Act of 1934. Petitioner Richard A. Holman, an attorney, is its president and sole stockholder.

R. A. Holman & Co. specialized in underwriting the securities of small companies unable to command the services of the major Wall Street investment firms. The major part of its business involved the underwriting of securities issues filed pursuant to Section 3(b) of the Securities Act of 1933 and Regulation A of the SEC governing offerings of $300,000 or less.

Both cases involved in the present petition—an administrative proceeding by the SEC against R. A. Holman & Co.[1] and a suit for injunction by the SEC against R. A. Holman & Co., Richard A. Holman, and others in the District Court for the Southern District

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[1] Docket No. 30276 in the Court below. Record citations relating to this case are to the printed Appendix for Petitioner in the Court below, cited as (Pet. App.), and to the transcript of proceedings, cited as (R.).

of New York[2]—arose out of an underwriting by R. A. Holman & Co. of securities of Pearson Corporation, a small Rhode Island boat company manufacturing pleasure craft.

This company was financed by R. A. Holman & Co. in a Regulation A offering in 1959 after other brokers had refused to underwrite it. (Pet. App. 228a-229a, 249a). The underwriting was a success, the price of Pearson stock rose, and Pearson's sales and earnings greatly increased. As the Court below acknowledged, this company "was not, in contrast to the companies involved in many securities fraud cases, a 'fly-by-night' company" but "produced and still produces an outstanding line of fiber-glass boats." (Appendix B, *infra,* p. 17a; 366 F.2d at 457).

1. The Administrative Proceeding

In 1960 the Pearson management decided to raise additional capital to finance further expansion. On March 30, 1960, Pearson filed a full registration (Form S-1) with the SEC in Washington covering the proposed offer. R. A. Holman & Co. was again the underwriter.

At that time, and until July 15, 1960, Byron D. Woodside was Director of the Division of Corporate Finance of the SEC. The major responsibility of this Division is to process registration statements filed by prospective offerors of securities. As the SEC conceded, Woodside had, during the period of his directorship, "ultimate responsibility" to the SEC for the

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[2] Docket No. 30039 in the Court below. Record citations relating to this case are to the printed Appendix for Appellants in the Court below, cited as (Apps. App.).

work of the Division. On July 15, 1960, Woodside was appointed a Commissioner of the SEC.

During the period of his directorship—and for two months thereafter—the Pearson registration remained pending in the SEC. The SEC did not even send Pearson a letter of comment, the first step in processing a registration statement, although the SEC acknowledges that time is of the essence in a securities issue.[3]

Finally, on September 16, 1960, the SEC issued an *ex parte* order suspending the original Pearson Regulation A offering which had been completed in 1959. (Pet. App. 33a-35a). Woodside was one of the three Commissioners voting to issue this order, although R. A. Holman & Co. was not informed of the fact until over a year and a half later, despite repeated efforts to obtain this information. (Pet. App. 62a-63a, 64a-66a, 105a).

On September 26, 1960, the SEC issued another order for public proceedings to determine whether to revoke R. A. Holman & Co.'s broker-dealer registration and to suspend or expel it from membership in the National Association of Security Dealers, Inc. The order alleged improper practices in the 1959 underwriting of Pearson stock. (Pet. App. 36a-43a).

The SEC thereafter consolidated the suspension proceeding against the Pearson offering and revocation proceeding against R. A. Holman & Co. and designated William W. Swift as Hearing Officer in the consolidated proceeding. (Pet. App. 46a-48a).[4]

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[3] 26 SEC Ann. Rep. 30 (1960).

[4] The proceeding was also expanded to include charges against R. A. Holman & Co. relating to an unsuccessful offering in another company in 1958 and against a former Holman salesman. (Pet. App. 49a-61a).

Hearings commenced December 16, 1960, and the SEC staff presented its case until March 6, 1962. R. A. Holman & Co. then commenced the defense.

During the course of that defense, counsel for R. A. Holman & Co. learned for the first time that Hearing Examiner Swift had passed the mandatory retirement age for Examiners and was serving under temporary appointment at the will of the SEC. R. A. Holman & Co. thereupon moved on May 15, 1962, to disqualify the Hearing Examiner on the ground that he lacked the independence of tenure and compensation required by law for Hearing Examiners. It also moved to strike the record thus far made. (Pet. App. 83a-92a).

The following facts about the Hearing Examiner's appointment then emerged:

(a) On October 31, 1957, Mr. Swift had been mandatorily retired as a Hearing Examiner; at that time he had been receiving a salary of $11,395 per year.

(b) The next day he was given a temporary one-year appointment by the SEC as a Hearing Examiner. His temporary appointment stated:

> "As provided by the provisions of Section 13(a) of the Civil Service Retirement Act, you may be separated at the will of the appointing officer."

(c) Each year thereafter Mr. Swift received another temporary one-year appointment as Hearing Examiner from the SEC. He also received salary increases, bringing his salary to $14,055 by 1960. Under each appointment he was subject to separation at the will of the SEC.

(d) If it had not been for these successive reappointments, he would have received merely his annual

retirement pay of about $4,700. This would also be his rate of compensation if he were "separated at the will" of the SEC. (Pet. App. 271a-284a).

On May 28, 1962, the SEC resolved this issue—which it acknowledged to be of first impression and great importance (Pet. App. 95a)—by denying the motion on the merits and also on the ground that it was not timely made. A notation at the end of the order of denial disclosed that Commissioner Woodside had participated in the decision. This was the first time that Woodside's participation in this proceeding had been publicly disclosed, although, as subsequently emerged, he had been participating throughout. (Pet. App. 93a-105a).

On May 11, 1962, the Court of Appeals for the District of Columbia Circuit had decided the case of *Amos Treat & Co.* v. *SEC,* 306 F.2d 260 (1962). The Court there invalidated action taken by the SEC with the participation of a Commissioner who had served with the divisional staff unit which investigated the case and was prosecuting the complaint.

Immediately on learning of Woodside's participation through the notation at the end of the SEC's Opinion of May 28, 1962, R. A. Holman & Co., in accordance with the *Treat* decision, sought to have the SEC discontinue the proceeding. In the alternative, it asked that the SEC hold a full evidentiary hearing to determine whether Woodside should be disqualified because of his prior staff service at the time the Pearson registration statement was pending. When the SEC failed to grant relief, R. A. Holman & Co. filed a complaint for an injunction in the District Court for the District of Columbia to restrain further proceedings

by the SEC on two grounds: (a) Commissioner Woodside's participation was unlawful; and (b) Hearing Examiner Swift was disqualified by reason of his lack of independence from the SEC.

On July 6, 1962, the District Court granted an injunction against further administrative proceedings on the basis of Woodside's participation.

While this injunction was on appeal by the SEC and while the SEC was restrained from acting in the administrative proceeding, the Commission continued its pursuit of Petitioners by filing a suit on March 15, 1963, in the District Court for the Southern District of New York against the company, Richard A. Holman, and three Holman salesmen. This action charged them with violations of the securities laws in connection with the offer and sale of Pearson common stock during the preceding six months. (Apps App. 2a-8a).

The Court of Appeals for the District of Columbia Circuit on June 13, 1963, reversed the grant of the injunction against the administrative proceeding solely on the ground that R. A. Holman & Co. had not exhausted its administrative remedies. *SEC* v. *R. A. Holman & Co.*, 323 F.2d 284 (1963), *cert. denied*, 375 U.S. 943. The Court emphasized that Holman should make its record on the unlawful participation of Commissioner Woodside before the SEC and the Court would then carefully review the SEC's determination of the matter. The Court stated:

> "We are satisfied that such claims as the appellee has here presented should be adduced in the first instance at the administrative level and any challenge to the resolution of these issues is subject to judicial review when the administrative record reaches us in due course . . . [A]t that

> stage we will scrutinize the issue of disqualification with great care." 323 F.2d at 287.

The Court also indicated the leeway to be accorded R. A. Holman & Co. in establishing its claims:

> "The party asserting disqualification must make his record in the administrative hearing. While the scope and nature of that inquiry has never been fully delineated it must be sufficient to allow the challenging party to introduce whatever relevant evidence he possesses bearing on disqualification since he, of course, has the burden of proof." (*Ibid.*)

In accordance with the mandate of the Court of Appeals, R. A. Holman & Co. then sought subpoenas from the Hearing Examiner, directed to Woodside and various staff employees of the SEC who had knowledge of Woodside's relationship to the Pearson investigation while he was Director of the Division of Corporate Finance. Hearing Examiner Swift denied the subpoenas on the ground that they were "a fishing expedition" and that R. A. Holman & Co. had not offered "substantial evidence to support its charge of disqualification against Commissioner Woodside." (R. 8219).

The Commission affirmed the denial of these subpoenas. *Commissioner Woodside himself participated in this decision.* (Pet. App. 120a-124a).

At the conclusion of the administrative hearings, Hearing Examiner Swift handed down a recommended decision adopting almost verbatim the proposed findings and conclusions of the SEC staff. When the case reached the Commission, Woodside announced that although he did not regard himself as disqualified, he had decided not to participate further in the

SEC's consideration of the matter because of the charge of disqualification against him.[5] Up to that point, he had participated in an undetermined number of rulings by the SEC on issues arising during the course of the proceedings.[6]

The SEC thereafter published its findings, opinion, and order that R. A. Holman & Co. had violated the securities laws, that its broker-dealer registration should be revoked, and that it should be expelled from the NASD. (Pet. App. 3a-32a).

R. A. Holman & Co. appealed from that order of the SEC to the Second Circuit.[7] The Second Circuit upheld the sufficiency of the evidence on which the SEC had based its order and rejected the contentions that the proceeding before the SEC violated the Administrative Procedure Act and denied due process of law. With respect to these contentions, the Court held that:

(a) "[W]e do not think the record before us establishes that Commissioner Woodside was disqualified within the meaning of the *Treat* case." P. 10a, *infra;* 366 F.2d at 524. The basis for this holding was that "the record here does not show that Woodside was 'engaged in the performance of investigative or prosecuting functions' in any proceedings related to the

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[5] He also stated that by withdrawing, he wished "to avoid providing a possible further occasion for delay." (R. 16242-4).

[6] The SEC did not, except in rare instances such as its opinion on the Hearing Examiner, note the names of the Commissioners who participated in rulings announced by it.

[7] The appeal could only be taken to the Second Circuit, rather than to the District of Columbia Circuit, because the SEC injunction action against petitioners was in the Second Circuit and it was desired to obtain joint argument of the two cases.

present case, so as to be barred by Section 5(c) of the Administrative Procedure Act from participation in adjudicatory proceedings against the petitioner." P. 11a, *infra;* 366 F.2d at 453.

(b) R. A. Holman & Co. was not unduly restricted in its inquiry into Woodside's disqualification by SEC denial of subpoenas for Woodside and the staff members. The Court ruled that the nature of Woodside's participation in the events leading up to the filing of charges against R. A. Holman & Co. had been adequately disclosed by statements in the SEC's answer and the affidavit of a staff member in the injunction suit against the SEC proceeding by R. A. Holman & Co. in the District Court for the District of Columbia.

No affidavit or statement of Woodside himself was before the Court below. The statements referred to were statements by others denying that Woodside had participated in any informal investigation of Holman's activities in connection with the Pearson registration statement, claiming that Woodside had not acquired "substantial knowledge" of the facts in issue, and asserting that the investigation had been under the supervision of Assistant Director of Corporate Finance Eisenhart. Eisenhart in an affidavit merely denied that he "discussed" the Pearson registration statement with Woodside until after Woodside left the Division and became a Commissioner.

The Court said:

> "In light of these statements, petitioner, who had the burden or proof on the disqualification issue . . . was obliged either to offer

evidence contradicting the sworn statements of the Commission, or to point out the inadequacy and inconsistency, if any, in the sworn statements, before he was entitled to subpoena the Commission members and staff."

(c) The challenge to the qualifications of Hearing Examiner Swift was not timely and it was therefore unnecessary to consider the merits of the disqualification motion against him. In this connection, the Court rejected the sworn statement of R. A. Holman & Co.'s counsel—never challenged or denied by the SEC—that he was unaware until April, 1962, that Swift was over the mandatory retirement age of 70 and was serving at the will of the SEC. (Pet. App. 84a-92a).

In its complaint in the injunction action in the District Court for the District of Columbia, plaintiff alleged:

"The information as to Mr. Swift's birthday came to plaintiff's and its counsel's attention for the first time on April 25, 1962.

* * *

"Prior to April 25, 1962 plaintiff had no knowledge of the facts that disqualify Mr. Swift as Hearing Examiner."

As to both these allegations, the SEC in its answer neither admitted nor denied them, which constituted an admission of their truth under Rule 8(d) of the Federal Rules of Civil Procedure.

The Court below nevertheless said:

"The hearing examiner's age must have been obvious at the beginning of the hearings in De-

> cember 1960, at which time Swift was over 73. The failure to challenge Swift's qualifications on the ground of his temporary reappointment over the retirement age at some early stage of the proceedings precludes the raising of a similar objection at this point." P. 14a, *infra*, 366 F.2d at 454.

Subsequently, in its opinion on the grant of rehearing in this case, the Court below acknowledged several factual errors and omissions in its original opinion. It made still another correction in response to a letter from the SEC. But it refused to disturb its affirmance of the judgment.

2. The Court Proceeding

The complaint in the SEC's injunction action in the Southern District of New York charged the company, Richard A. Holman, and three Holman salesmen with violations of Section 17(a) of the Securities Act of 1933 and Section 15(c)(1) of the Securities Act of 1934. It alleged that the defendants embarked on a selling campaign in Pearson stock in the fall of 1962, during which they had made statements as to the future market price of Pearson stock and had omitted to state facts which would show the lack of any reasonable basis for these predictions. The suit sought an injunction against future violations in the offering and sale of Pearson stock and any other security. (Apps. App. 2a-8a).

The SEC's allegations were vigorously contested by petitioners. Judge Bonsal denied the SEC's request for a preliminary injunction. (Apps. App. 1a).

The case then came on for trial before Judge Wham, a retired district judge of the Northern District of

Illinois, sitting by designation. The SEC introduced evidence that a salesman had offered investors Pearson stock at $4½ a share and had stated that Pearson stock would probably rise to about $10 in the next several months. Petitioners introduced evidence that there was a reasonable basis in fact for such predictions:

(a) Pearson had just reported the highest sales and earnings in its history in its report for the first six months of 1962; the president of Pearson publicly stated as his opinion that sales and earnings for the rest of 1962 would also be at a record level and that sales and earnings would be even higher in 1963;

(b) the market history of the stock showed that it had risen at the start of previous annual New York Boat Shows, and the 1963 Boat Show was approaching at the time the predictions were allegedly made;

(c) in 1960 the stock had risen from $4¼ to $13¾ in a matter of two months, an increase of 200%, and had traded for long periods at over $10 a share;

(d) Pearson had been merged with Grumman Boats, Inc., a subsidiary of Grumman Aircraft, in December, 1960, which resulted in Grumman Aircraft owning over 61% of Pearson's common stock. Grumman executives went on the Pearson Board of Directors. Grumman had helped Pearson obtain needed financing. In March, 1963, Pearson was merged with Grumman Allied, a newly created Grumman subsidiary. The SEC suit against Petitioners was commenced on

the eve of this merger, despite the fact that Pearson was about to disappear from the corporate scene.

(e) The Grumman Aircraft Engineering Corporation was showing continuing interest in Pearson and giving it financial support. The Grumman affiliation gave Pearson additional managerial and financial strength.

At the conclusion of the trial, Judge Wham adopted verbatim the SEC's proposed findings of fact and conclusions of law. The Court granted a final injunction exactly as proposed by the SEC. Judge Wham merely accepted the proposed findings and order presented him by the SEC without so much as a comma change. (Apps App. 404a-422a). This is the practice criticized by this Court in *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651, 656-657 (1964).

With respect to the predictions of increases in the price of Pearson stock, the Court found that "[t]here was no basis in fact for any of these predictions." (Apps. App. 408a). It concludes that:

> "It is well settled that predictions by securities salesmen of market price increases in the stock being sold, whether such predictions be couched in the form of a mere opinion or otherwise, are, when made recklessly or without reasonable basis in fact, violative of the anti-fraud provisions of the federal securities laws." (Apps. App. 414a).

At no point in its findings or conclusions did the District Court make any analysis of Pearson's financial condition to determine whether there was a reasonable basis in fact for the predictions. At no point did it analyze the evidence adduced by petitioners

which showed that there was a reasonable basis in fact for the predictions.

On appeal to the Second Circuit, the Court affirmed the judgment below. The Court conceded at the outset that:

> "we are not convinced that all of the statements and omissions described by the trial court were materially misleading under the circumstances in which they were made (or not made)." P. 19a, *infra;* 366 F.2d at 457.

With respect to the matter of the price predictions, however, the Court held:

> "the specific price predictions were themselves violative of the antifraud provisions of the federal securities laws, since no adequate basis existed for representations so optimistic." P. 22a, *infra;* 366 F.2d at 458.

Like the District Court, the Court of Appeals failed to indicate any evidence in the record showing that no adequate basis existed for such predictions. Its opinion, like the findings and conclusions of the District Court, is entirely silent on any facts or circumstances which indicate that these predictions were without reasonable basis at the time they were made.

REASONS FOR GRANTING THE WRIT

This Petition presents important issues concerning the proper exercise by administrative agencies of their quasi-judicial powers. It raises the question whether administrative agencies are free from fundamental principles of fair adjudication which have always governed our courts—that adjudicative officials

should not be dependent on the authority appointing them for their continued tenure and compensation and that investigative, prosecutorial, and adjudicative functions should not be intermingled in the same individual. This Court should resolve these questions because of the public interest in assuring that administrative agencies which have the power of economic life and death over individuals carry out their adjudicative functions in accordance with high procedural standards.

This Petition also presents an important question of statutory interpretation of the securities laws: whether a federal District Court, enforcing the anti-fraud provisions of these laws, is free, at the SEC's behest, to impose a *per se* rule of violation on predictions as to future stock prices, although the SEC, enforcing the same provisions in an administrative proceeding, is required to demonstrate the facts or circumstances which deprive such predictions of any reasonable basis in fact. This is a question of great moment to the securities industry, which requires reasonable legal certainty in such matters in order to carry out its function of distributing securities.

I. The Administrative Proceeding Is Invalidated Because Hearing Examiner Swift Served at the Will of the SEC, in Violation of the Administrative Procedure Act and Principles of Due Process of Law.

This contention, as the SEC itself concedes:

> "raises a question of first impression, having government-wide implications affecting the validity of all proceedings presided over by retired Hearing Examiners who have been re-employed." (Pet. App. 95a).

Section 11 of the Administrative Procedure Act provides in unmistakable terms that:

> "Examiners shall be removable by the agency in which they are employed only for good cause established and determined by the Civil Service Commission . . . after opportunity for hearing and upon the record thereof."

The statute also provides that:

> "Examiners shall receive compensation prescribed by the [Civil Service] Commission independently of agency recommendations . . . ."

The purpose of this section is beyond doubt or dispute. The authoritative legislative history of the APA states:

> "Section 11 recognizes that agencies have a proper part to play in the selection of examiners in order to secure personnel of the requisite qualifications. However, once selected, *under this bill the examiners are made independent in tenure and compensation* by utilizing and strengthening the existing machinery of the Civil Service Commission.
>
> "Accordingly, Section 11 requires agencies to appoint the necessary examiners under the civil service and other laws not inconsistent with the bill. But *they are removable only for good cause determined by the Civil Service Commission after a hearing, upon the record thereof, and subject to judicial review. Moreover, their compensation is to be prescribed and adjusted only by the Civil Service Commission acting upon its independent judgment.*" Administrative Procedure Act, Legislative History, Senate Document No. 248, 79th Cong., 2d Sess. (1946), p. 371 (Emphasis supplied).

It is clear that Hearing Examiner Swift lacked the independence from the SEC required by the APA.

None of the facts as to this point is in dispute. As a retired Hearing Examiner, he was serving under a temporary year-to-year appointment, terminable at the will of the appointing agency, the SEC. Each time he was reappointed he was specifically informed that he could be "separated at the will of the appointing officer." He was subject to dismissal by the SEC without the good cause, hearing, and judicial review explicitly provided for in the APA. His annual reappointment was completely within the discretion of the SEC.

Moreover, his compensation as well as his tenure were within the control of the SEC. The SEC's willingness to reappoint him meant the difference between a salary which was over $14,000 a year by the time the present proceeding began and a retirement annuity of $4,700.

This provision of the APA is not a technical housekeeping rule of agency practice. It is a congressional declaration of the fundamental principle that an adjudicative officer should be given independence from outside pressures which might prevent him from holding the balance true between the parties who come before him for decision.

This is the same principle of independence guaranteed to Federal judges by the provision of Article III of the Constitution that they "shall hold their Offices during good Behavior, and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office." Belief in the independence of adjudicative officers of course antedates the Constitution. One of the grievances asserted by the colonists against the King in the Declaration of Independence

was that he "had made Judges dependent on his Will alone for the tenure of their offices and the amount and payment of their salaries."

A robust understanding of human motivation underlies this principle. As Hamilton wrote in explanation of the Constitutional provision:

> "Next to permanency in office, nothing can contribute more to the independence of the judges than a fixed provision for their support . . . . *In the general course of human nature, a power over a man's subsistence amounts to a power over his will.*" The Federalist Papers, No. 78. (Emphasis supplied).

This Court has repeatedly recognized that even men of the highest motivation and the best intentions may be unfairly influenced by the possibility of a financial stake in how they decide cases. In *Tumey* v. *Ohio,* 273 U.S. 510 (1927), in which this Court unanimously invalidated on due process grounds a procedure whereby the officer trying a case could receive court costs in the event of conviction, Chief Justice Taft stated:

> "There are doubtless mayors who would not allow such a consideration as $12 costs in each case to affect their judgment in it, but the requirement of due process of law in judicial procedure is not satisfied by the argument that men of the highest honor and the greatest self-sacrifice could carry it on without danger of injustice. Every procedure which would offer a possible temptation to the average man as a judge to forget the burden of proof required to convict the defendant, or which might lead him not to hold the balance nice, clear and true between the state and the accused denies the latter due process of law." 273 U.S. at 532.

It is unfair to a Hearing Examiner to require that he function with the dispassionateness of a judge and at the same time deny him the independence of tenure and compensation guaranteed to judges by the Constitution and to Hearing Examiners by Section 11 of the APA. It is unfair to parties to subject them to a quasi-judicial administrative proceeding in which the Hearing Examiner is not insulated from the subtle pressures of dependency for continued tenure and compensation on the agency which appointed him.

Petitioner R. A. Holman & Co. was clearly prejudiced by being subjected to a proceeding before a disqualified Hearing Examiner. By decision of this Court, an agency is required to give weight to the decision of an "impartial, experienced examiner who has observed the witnesses and lived with the case." *Universal Camera Corp.* v. *National Labor Relations Board*, 340 U.S. 474 (1951). Indeed, it is precisely because of the probative force which must be given to the decision of the Hearing Examiner that "section 11 of the Administrative Procedure Act contains detailed provisions designed to maintain high standards of independence and competence in examiners." *Id.* at 495.

In evident recognition that it would be defending the indefensible to try to justify Hearing Examiner Swift's participation, the Court below declined to reach the merits of this contention. Instead it rested its decision solely on an alleged failure by R. A. Holman & Co. to make a "timely" challenge to the Hearing Examiner's qualifications.[8]

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[8] Section 7(a) of the APA provides that "upon the filing in good faith of a timely and sufficient affidavit of personal bias or disqualification of any such officer, the agency shall determine the matter as a part of the record and decision in the case." 5 U.S.C. § 1006(a).

In ruling thus, the Court below departed from the decisions of this Court as to what constitutes a timely challenge to the qualifications of an administrative hearing officer.

It is clear that the requirement of timely filing is intended to assure that the claim of disqualification can be passed on in the first instance by the agency before the administrative process is completed. Thus, in *Riss & Co.* v. *United States,* 341 U.S. 907 (1951), this Court held that a challenge made to the qualifications of a hearing officer on the last day of the hearings was timely.

In the present proceeding, objection to Swift's qualifications was made and decided by the SEC twenty months before the end of the hearings; twenty-nine months before Swift's recommended decision; and forty-two months before the final SEC decision.

Contrary to the opinion of the Court below, the decision in *Riss* was in no way qualified by this Court's subsequent decision in *United States* v. *L. A. Tucker Truck Lines,* 344 U.S. 33 (1952). *Tucker* merely held that objections to a Hearing Examiner not presented to the agency in the first instance are untimely. This Court stated that:

> "A litigant in such a case as this who does make such demand at the time of hearing is entitled to an examiner chosen as the Act prescribes." 344 U.S. at 36.

If *Tucker* in any way departs from *Riss,* or if this Court no longer adheres to this principle, it is for this Court to say so now.

Moreover, the Court below not only departed from established legal principles in its effort to avoid meet-

ing the contention on the merits, it also made an extraordinary finding of fact. Without ever seeing Swift and in the face of the undisputed sworn statements of R. A. Holman & Co.'s counsel that he did not know of Swift's age and status until April, 1962, the Court below concluded that counsel must have known Swift's age at the outset of the administrative proceeding.[9]

It also totally disregarded the undenied allegations in the complaint in the injunction action in the District Court for the District of Columbia, in which plaintiff stated:

> "The information as to Mr. Swift's birthday came to plaintiff's and its counsel's attention for the first time on April 25, 1962."
>
> * * *
>
> "Prior to April 25, 1962, plaintiff had no knowledge of the facts that disqualified Mr. Swift as Hearing Examiner."

The SEC admitted these allegations by failing to deny them in its answer in the injunction action, since under Rule 8(d) of the Federal Rules of Civil Procedure:

> "Averments in a pleading to which a responsive pleading is required, other than those as to the amount of damage, are admitted when not denied in the responsive pleading."

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[9] Counsel were not given access to the SEC files showing the basis on which Swift was given his temporary reappointments until May, 1962, after they had filed the motion to disqualify him.

Even if his age had been known at the outset of the proceedings, this would not have constituted disclosure that he was serving at the will of the SEC.

See *Reed* v. *Hickey,* 2 F.R.D. 92 (E.D. Penn. 1941); *Mahano* v. *United States,* 192 F.2d 873, 876 (1st Cir. 1951).

The conclusion of untimeliness is therefore untenable. Indeed, it is simply an additional reason for this Court to grant review in order to correct an obvious error in the interpretation of what is a timely disqualification motion under Section 7 of the APA.

II. The Administrative Proceeding Is Invalidated by the Participation of Commissioner Woodside.

Section 5(c) of the APA provides in unqualified terms that:

> "No officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review pursuant to section 1007 of this title except as witness or counsel in public proceedings." 5 U.S.C. 1004(c).

In this case it is undisputed that Commissioner Woodside was head of the Division of Corporate Finance of the SEC for a period of three and a half months during which time the Pearson registration statement was being processed there. It is conceded that he had responsibility to the SEC for the work of this division. It is undisputed that this registration statement led to the SEC investigation which in turn culminated in the suspension of the exemption for the Pearson offering and in the administrative proceeding against R. A. Holman & Co. It is also undisputed that Woodside participated throughout the administrative proceeding—joining in an undetermined number of

rulings by the SEC, including rulings relating to the question of his own disqualification—and finally withdrew, still asserting he was not disqualified, only on the eve of final argument before the SEC, over four years after the proceeding was commenced.

Such participation by Woodside is in conflict with the mandate of Section 5(c) of the APA and with the doctrine laid down by the Court of Appeals for the District of Columbia Circuit in *Amos Treat & Co.* v. *SEC, supra,* in which the Court said:

> "We are unable to accept the view that a member of an investigation or prosecuting staff may initiate an investigation, weigh its results, perhaps then recommend the filing of charges, and thereafter become a member of that commission or agency, participate in adjudicatory proceedings, join in commission or agency rulings and ultimately pass upon the possible amenability of the respondents to the administrative orders of the commission or agency. So to hold, in our view, would be tantamount to that denial of administrative due process against which both the Congress and the courts have inveighed.
>
> "Enough has been said to demonstrate the basis for our conclusion that an administrative hearing of such importance and vast potential consequences must be attended, not only with every element of fairness but with the very appearance of complete fairness. Only thus can the tribunal conducting a quasi-adjudicatory proceeding meet the basic requirement of due process." 306 F.2d at 226-67.

The Court below distinguished the *Treat* doctrine on a transparently insubstantial ground—that in *Treat* the challenged Commissioner himself disclosed his

participation in the investigation which led to the administrative proceedings, whereas here Woodside stood mute while others on the staff (some patently without knowledge) denied that Woodside had actively participated or had acquired "substantial knowledge" of the case. (It should be noted that in *Treat* the Commissioner there involved denied active participation but he made the apparently fatal mistake of being frank with the Court, and stating what part he had actually played, a role which the Court interpreted as more than sufficient to constitute active participation.) This distinction turns nondisclosure by a challenged Commissioner into a tactical advantage for him, a means of blocking the inquiry into his disqualification, and would go far toward nullifying the *Treat* doctrine.

III. The SEC Denied Due Process in Curtailing Inquiry Into the Disqualification of Commissioner Woodside.

The SEC's restriction of inquiry into the facts relevant to the disqualification of Commissioner Woodside was itself a denial of due process to R. A. Holman & Co. in the administrative proceeding. If the record here does not show sufficient participation by Woodside in the investigation to disqualify him to sit in judgment on R. A. Holman & Co., it is precisely because the SEC—Woodside again participating—denied R. A. Holman & Co. the right and opportunity to make its record.

The District of Columbia Circuit, in holding that R. A. Holman & Co.'s interlocutory effort to enjoin the administrative proceeding was premature, specified that the company was entitled to a plenary administra-

tive hearing to inquire into the claim of disqualification. 323 F.2d at 287.

Instead R. A. Holman & Co. was allowed no further inquiry at all, much less a plenary one. The SEC denied it the right to subpoena staff members having knowledge of Woodside's role. Moreover, the SEC denied it the right to subpoena the man who had unique knowledge of Woodside's relation to the investigation before he became a Commissioner: Woodside himself. And Woodside participated in the SEC decision not to allow a subpoena for himself!

R. A. Holman & Co. was thus denied information it needed to carry the burden which was placed on it to prove Commissioner Woodside's disqualification. Yet the Court below, in upholding the denial of the administrative subpoenas, stated that R. A. Holman & Co. should have come forward with the very evidence of disqualification which it was attempting to utilize the subpoena process to obtain. The integrity of the administrative process is compromised by such an extraordinary concept of proper administrative procedure, which this Court would surely find intolerable in a judicial proceeding: "the ordinary rule, based on considerations of fairness, does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary." *Campbell* v. *United States,* 365 U.S. 85, 96 (1961).

At the very minimum, due process of law (and the decision of the Court of Appeals for the District of Columbia Circuit in the earlier stage of this same proceeding) required disclosure of the facts relevant to this issue by the persons having knowledge, including the Commissioner involved. It is not due process,

when an issue of disqualification is clearly raised by strong *prima facie* evidence, for the only persons having full personal knowledge to refuse to state facts peculiarly and exclusively within his knowledge and necessary to permit the courts to resolve the issue.

This Court should grant review to assure that administrative agencies adhere to the fundamental principle sought to be implemented in Section 5(c) of the APA, that:

> "A fair trial in a fair tribunal is a basic requirement of due process. Fairness of court requires an absence of actual bias in the trial of cases. But our system of law has always endeavored to prevent even the probability of unfairness . . . . [T]o perform its high function in the best way 'justice must satisfy the appearance of justice.'" *Re Murchison,* 349 U.S. 133, 136 (1955).

In the words of Chief Justice Hughes:

> "The maintenance of proper standards on the part of administrative agencies in the performance of their quasi-judicial functions is of the highest importance and in no way cripples or embarrasses the exercise of their appropriate authority. On the contrary, it is in their manifest interest. For, as we said at the outset, if these multiplying agencies deemed to be necessary in our complex society are to serve the purposes for which they are created and endowed with vast powers, they must accredit themselves by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play." *Morgan* v. *United States,* 304 U.S. 1, 22 (1938).

IV. The Court Below Misapplied the Securities Act by Holding Stock Price Predictions Violative of Law in the Absence of Any Facts or Circumstances Showing That There Was No Reasonable Basis in Fact for the Predictions.

The Court below held that the stock price predictions at issue in the District Court proceeding "were themselves violative of the antifraud provisions of the federal securities laws, since no adequate basis existed for representations so optimistic," relying on an earlier Second Circuit decision, *Berko* v. *SEC,* 316 F.2d 137, 143 (2d Cir. 1963). P. 22a, *infra.,* 366 F.2d at 458.

We submit that the Court below thereby misinterpreted the antifraud provisions of the securities laws and misapplied the *Berko* doctrine, totally overlooking the earlier opinion in the same case by Judge Marshall, *Berko* v. *SEC,* 297 F.2d 116 (1961).

Berko I held that in order for the SEC in an administrative proceeding to find statutory violations based on predictions of future stock prices, the SEC must clearly set forth in its decision the circumstances which made the stock price predictions without reasonable basis in fact at the time made. It must analyze the financial condition of the company involved and the information relied on by the salesman, and demonstrate the lack of basis for the predictions. In other words, there is no *per se* rule of violation based on stock price predictions.

Berko I was an administrative proceeding under the same statute as in the present case, involving prediction by a salesman that a stock would rise from $7 to $15 a share. The Court remanded the case to the SEC because of the Commission's failure to support, by analysis of the record, its findings and conclusion

that there was no reasonable basis in fact for the salesman's prediction. Judge Marshall wrote:

> "Although the SEC is far better equipped for such analysis than this Court, it failed to make any findings along these lines . . . . [T]he Commission eschewed any investigation or discussion of the information which Berko had and which he relied on." 297 F.2d at 118.

Judge Marshall made it explicit that this requirement derives from the statute itself:[10]

> "[T]he statute specifies the misleading nature of any statement is to be determined in the light of all the circumstances. But the Commission has not stated what surrounding circumstances persuaded it to rule this way. We should not and cannot resolve these questions without more complete findings and a clearer indication of the precise basis for its decision." *Ibid.*

As Judge Marshall stated in the companion case to *Berko I, Kahn v. SEC,* 297 F.2d 112, 114 (1961), which was remanded for the same purpose:

> "[A] straightforward affirmance on these grounds [that the salesman made optimistic stock price predictions] would establish an extraordinarily broad *per se* rule. *Upon remand, the Commission, in accordance with the statute, should state which, if any, of the surrounding circumstances made this statement 'misleading.'*" (Emphasis supplied).

It was only after *Berko I* was returned to the SEC for this purpose that the Commission decision was af-

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[10] The relevant statutory provision prohibits sales by means of "any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77(a).

firmed in *Berko II,* the sole authority relied upon by the Court below for its holding that the price predictions in the present case violated the law.

In the present case this Court can search the findings and conclusions of the District Court and the opinion of the Court of Appeals in vain for any statement of the circumstances which made the price predictions without adequate basis in fact at the time they were made. There is not a line of analysis of the financial condition of Pearson at the time, or of the information on which the salesman relied. The courts below also totally ignored the Petitioners' evidence showing that there was a reasonable basis for the predictions.

Thus, the decision below imposes the very *per se* rule, with respect to stock price predictions, which *Berko I* held would violate the statutory mandate.

There is no justification for the staff of the SEC to ask the District Court to apply such a *per se* rule when, under *Berko I,* the SEC cannot do so in an administrative proceeding. The statutory requirements as to what constitutes a violation govern the courts and the SEC equally. The SEC should not be able to circumvent the duty imposed on it in an administrative proceeding to analyze the record simply by asking a District Court to adopt its proposed findings and conclusions wholesale and verbatim without any such analysis.

The process of decision which this case exhibits leaves the securities industry in a state of uncertainty inimical to the performance of its marketing func-

tions.[11] Do stock price predictions constitute a *per se* violation of the law? If not, under what circumstances will they? And do the answers depend on the forum in which the SEC elects to bring its charges?

The SEC has been criticized for its failure to exercise its rule-making powers to give notice and certainty in advance, instead of resorting to the unpredictable process of litigation to formulate policy.[12] Petitioners are unfortunate victims of that failure of the SEC.

Only review by this Court can dispel the uncertainties in the interpretation of the securities laws created by the decision below.

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[11] "Although the courts have exhibited a tendency to give the Commission substantial latitude in its efforts to suppress boiler shops . . . they have also expressed a deep aversion for the use of *per se* doctrines to prohibit expressions of values in the sale of securities . . . . It is obvious to me that these doctrines make it infinitely more difficult to sell the securities of a new company than those of an established company." Heller, *The Boiler-Shop Cases and The Reasonable Basis Rule*, Duke University School of Law, Conference on Securities Regulation, p. 81 (1964).

[12] Judge Friendly has said:

"I have sometimes felt that the Commission was slower to make particularized rules, especially under the 1934 Act and the Investment Advisors Act, than it needed to be. A rather high degree of precision seems especially desirable when an infraction of the rules can be made the basis for disciplinary proceedings." Proceedings, Conference on Codification of the Federal Securities Laws, 22 Business Lawyer 793, 901 (1967).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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September 13, 1967

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 419—September Term, 1965.

(Argued June 21, 1966 Decided September 21, 1966.)

Docket No. 30276

R. A. HOLMAN & CO., INC.,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

Before:

WATERMAN, MOORE and KAUFMAN,

Circuit Judges.

Petition for review of an order of the Securities and Exchange Commission (SEC) revoking petitioner's registration as a broker and a dealer, expelling petitioner from membership in the National Association of Securities Dealers, Inc., and making permanent an earlier SEC order temporarily suspending the exemption from registration requirements of an offering of securities. Affirmed.

SIDNEY P. HOWELL, JR., New York, N. Y. (Rogers, Hoge & Hills, New York, N. Y.; Arnold & Porter, Washington, D. C.; and Richard A. Holman, New York, N. Y.; with him on the brief), *for the petitioner.*

DAVID FERBER, Solicitor, Securities and Exchange Commission, Washington, D. C. (Philip A. Loomis, Jr., General Counsel; Edward B. Wagner, Special Counsel; and Theodore Sonde, Attorney; all of the Securities and Exchange Commission, Washington, D. C.; with him on the brief), *for the respondent.*

MOORE, *Circuit Judge*:

This is a petition by R. A. Holman & Co., Inc., a New York corporation formerly registered as a broker and a dealer under the Securities Exchange Act of 1934, Section 15(b), 15 U.S.C. § 780(b), for review of an order of the Securities and Exchange Commission (SEC), revoking that registration, expelling petitioner from membership in the National Association of Securities Dealers, Inc., and making permanent an earlier SEC order which temporarily suspended the exemption from registration requirements of an offering of securities. Petitioner challenges the SEC order on grounds both of insufficiency of evidence and procedural defects.

A. THE SUFFICIENCY OF THE EVIDENCE.

The order under review was based upon findings by the SEC that officers of the petitioner had made or caused to be made false and misleading statements and had otherwise willfully violated federal securities laws and regulations in connection with the offer and sale to the public of stock in two corporations: Precise Development Corporation (Precise) and Pearson Corporation (Pearson).

1. *The Offer and Sale of Precise Stock.*

R. A. Holman & Co. was registered with the SEC as a broker-dealer in September, 1958. Its first underwriting was of a Regulation A offering by Precise, a manufacturer of electronic equipment, of 60,000 units at $5 per unit, each unit consisting of one share of common stock and one share of preferred convertible into four shares of common. The offering started on October 14, 1958, and was reported terminated on December 31, 1958, with the sale of 33,220 units.

The evidence adduced supports the SEC's conclusion that R. A. Holman, the president and sole stockholder of R. A.

Holman & Co., and R. A. Holman & Co. were guilty of a number of willful violations of the Securities Act and of the Securities Exchange Act in connection with the offer and sale of Precise stock.

Rule 10b-6, 17 C. F. R. § 240.10b-6, provides that it shall constitute a "manipulative or deceptive device or contrivance" under § 10b of the Securities Exchange Act, 15 U. S. C. § 78j(b), for an underwriter to purchase securities while he is still participating in their distribution. "Distribution" comprises "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *Lewisohn Copper Corp.*, 38 S. E. C. 226, 234 (1958). In the course of the Precise offering, petitioner allocated 13,000 units to the account of Ludwig J. Kabian on December 30, 1958, on a delayed delivery basis, payment not to be made until February 3, 1959. Kabian testified that he had been reluctant to take the units but that Holman had said he could cancel out if he wanted to and that it was on this basis that Kabian agreed to have the sale to him confirmed "with the right of turning them down." Holman testified that the sale was an ordinary "delayed delivery" sale. In January, after some investigation of the company, Kabian decided to cancel. Petitioner took the units back, and Holman bought them for himself. In March 1959 Holman put some 10,000 shares of Precise common into petitioner's trading account, and the shares were sold to the public.

Upon these facts, the SEC was justified in concluding that "distribution" was still in process until the stock originally allotted to Kabian was sold. A cancellation of a bona-fide purchase order will not reopen a distribution, where there was no reason for the underwriter to believe that the purchase order would be cancelled. *Edgerton, Wykoff & Co.*, 36 S. E. C. 583, 586 (1955). Here, however, there was a real possibility at the time of purchase that

Kabian would cancel; and it naturally made the offering appear better than it actually was to report that 33,200 shares were sold by December 31, 1958, without noting the questionable firmness of Kabian's commitment.

Rule 15c1-5, 17 C. F. R. § 240.15c1-5, provides that the term "manipulative, deceptive, or other fraudulent device or contrivance," used in § 15(c)(1) of the Securities Exchange Act, 15 U. S. C. 78o(c)(1), includes any act of a broker or dealer controlling the issuer of a security designed to effect or induce the purchase or sale of the security, unless the fact of control is disclosed in writing before the act. The record supports the inference that Holman was "controlling" Precise as of December 9, 1958, and it is certain that this fact was not disclosed to prospective subscribers to the distribution. At the end of August 1958, 130,000 shares of Precise common were outstanding: 55,000 in the name of Melville Byron, 75,000 in the names of Eugene and Albert Silber. By December 9, 1958, no more than 15,220 shares of the new offering had been sold, so that the total shares out were 145,220. On that day, the Silbers assigned their interest in their Precise stock to Holman, making him majority stockholder. To be sure, this stock was to be held in escrow, with restrictions on transferability, evidently to prevent its inclusion in the computation of the Regulation A offering; but the Silbers agreed to give Holman irrevocable proxies covering the stock. A Holman slate of directors was nominated, resigning only on May 30, 1959, when Holman and his company relinquished control to Byron.

Finally, Holman and two of his company's employees, Eisenberg and Powell, represented to customers that the stock would soon appreciate in value. There was, as the SEC found, no basis for these representations, which were therefore misleading and unjustifiable. See *Berko* v. *SEC*, 316 F. 2d 137, 143 (2d Cir. 1963). Though the company had good product engineering and was in a growing field

(stereo equipment), its financial history had been extremely unsatisfactory, it faced severe competition, and its difficulties had been reflected in the sharp drop in the market after the offering was closed uncompleted. Holman was aware of the scarcity of funds from which the company suffered—a scarcity not relieved by the unsuccessful offering.

2. *The Offer and Sale of Pearson Stock.*

The record also supports the SEC's conclusions as to the existence of willful violations by the petitioner in connection with the offer and sale of Pearson stock.

Pearson Corporation was a Rhode Island corporation which manufactured fiberglass boats. On March 30, 1959, it filed a notification and offering circular under Regulation A for the purpose of obtaining an exemption from the registration requirements of the Securities Act of 1933 with respect to a proposed public offering of 175,000 shares of common stock at $1 per share. Holman underwrote the issue and on October 29, 1959 reported that the offering had commenced on April 24th and was successfully completed on April 28, 1959. Between April 24th and 28th, Holman & Co. sold 15,000 shares to Holman, 4,000 shares to members of his immediate family, 12,500 shares to his close relatives, 1,500 shares to his secretary, and 8,100 shares to Stanley D. Halperin, Holman & Co.'s counsel, who later became Holman's law partner. The stock rose quickly in the aftermarket, tripling within a week. On April 28, 1959, Holman & Co. repurchased the shares sold to Halperin, and 4,500 of those sold to the secretary and to one relative. Other repurchases from Holman, his family and relatives, and the secretary amounted to about 6,500 shares in May, 13,700 shares from June to September, and about 6,000 shares in November and December.

The SEC found these activities to be violative of the securities laws, in that the distribution lasted until the resale to the public of stock repurchased from Holman's

relatives and affiliates; that the plan of purchase by affiliates and repurchase and resale by petitioner was never disclosed; that the repurchase by petitioner violated Rule 10b-6, since the distribution was still going on; and that it was misleading to say that the offering price to the public was to be $1 per share, since petitioner envisaged allocating a large portion of the 175,000 shares said to be "publicly" offered to his affiliates, with a view to repurchase and resale to the public within a short period after the offering was announced to be closed.

The record supports the conclusions of the Commission. The interval between purchase by the affiliates and repurchase and sale to the public was so short that it seems likely that it was part of a preconceived plan with manipulative effects: the allocation to relatives would create an artificial scarcity of shares available to people genuinely interested in investment, which in turn would make for an artificially stimulated ("hot") aftermarket, in which the affiliates could unload their shares.

Petitioner argues that he was unfairly surprised, since the SEC had not previously forbidden participation by affiliates of the underwriter in a new issue, and indeed had not permitted disclosure of the fact that officers and affiliates of the underwriter intended to invest in the offering. However, the SEC decision with respect to the Pearson offering does not rest upon a prohibition of underwriter investment in the offering underwritten, but rather upon a disapproval of purchases by affiliates of the underwriter in order to create an illusion of scarcity and with a view to quick resale at "hot" prices in the aftermarket. Such disapproval had previously been made explicit in *Lewisohn Copper Corp.*, 38 S. E. C. 226, which was promulgated on March 18, 1958—a number of months before the commencement of the offering in Pearson.

In addition, the record indicates that between August 1959 and March 1960 Holman & Co. in several instances

sent confirmations of sales of Pearson stock to customers who had not in fact agreed to purchase such securities. Although the transactions appear to have involved fairly minor amounts, such confirmations of unauthorized transactions are violative of the anti-fraud provisions of the securities acts. *Shelley, Roberts & Co.*, 38 S. E. C. 744, 751 (1958).

B. The Fairness of the Proceedings.

Petitioner contends that even if the evidence against it was substantial enough to support the revocation of its registration and the rest of the SEC order, the proceedings before the SEC were invalid for failure to comply with standards of procedural fairness set forth in the Administrative Procedure Act and inherent in the due process clause of the Constitution.

1. *Separation of Prosecutorial and Adjudicatory Functions.*

Byron D. Woodside was Director of the Division of Corporation Finance in the SEC from March 30, 1960, until July 15, 1960, on which latter date he was appointed a member of the Commission itself. The proceedings leading up to the order under review started on September 16, 1960, when the SEC temporarily suspended the Regulation A exemption from registration of the Pearson offering discussed above. Commissioner Woodside was one of the three Commissioners who voted to issue this order. On September 26, 1960, the SEC ordered public proceedings to be held to determine whether or not to revoke petitioner's broker-dealer registration or to suspend or expel it from membership in the National Association of Security Dealers, Inc., because of petitioner's conduct in the Pearson offering. In October 1960, the SEC consolidated the proceedings concerning the suspension of exemption of the Pearson offering and the proceedings concerning petitioner's broker-dealer registration, and designated William

W. Swift as the hearing officer in the consolidated proceedings. In November 1960, charges concerning the offering of Precise stock were added to those concerning the Pearson offering in the registration revocation proceedings.

On May 11, 1962, the Court of Appeals for the District of Columbia handed down the decision in *Amos Treat & Co.* v. *SEC*, 305 F. 2d 260. In that case, the SEC had started a public hearing to determine whether or not Amos Treat & Co's broker-dealer registration should be revoked and whether or not it should be expelled from NASD. The firm sought an injunction against further prosecution of the proceedings, contending that the proceedings were contrary to due process in that Commissioner Manuel F. Cohen was participating in the revocation proceedings, although he had been Director of the Division of Corporation Finance at the time it had begun formal investigation of the registration out of which the revocation proceedings arose. The District of Columbia Circuit held that the proceedings should be enjoined on the ground that Commissioner Cohen was disqualified and indicated that new revocation proceedings could be commenced in which he would not participate. The Court stated:

> "We are unable to accept the view that a member of an investigative or prosecuting staff may initiate an investigation, weigh its results, perhaps then recommend the filing of charges, and thereafer become a member of that commission or agency, participate in adjudicatory proceedings, join in commission or agency rulings and ultimately pass upon the possible amenability of the respondents to the administrative orders of the commission or agency. So to hold, in our view, would be tantamount to that denial of administrative due process against which both the Congress and the courts have inveighed."

306 F. 2d 260, 266-67.

On May 28, 1962, the SEC in the case at bar handed down an order denying petitioner's motion for the disqualification of the hearing officer. The SEC opinion indicated that Commissioner Woodside had participated in the denial of the motion. This was the first time his participation had been disclosed. On June 1, 1962, petitioner moved—as it had done before—that the Commission furnish the names of the Commissioners who had participated in the SEC's orders and rulings in the consolidated proceedings. The SEC declined to furnish this information. Petitioner then sought an injunction against further proceedings, on the basis of the decision in *Amos Treat & Co.* The District Court for the District of Columbia granted the injunction requested; the Court of Appeals reversed, distinguishing *Treat* on the grounds that in that case the Commission did not deny that Commissioner Cohen had to some extent participated in the investigation of the registration before he became Commissioner, whereas in this case the SEC affidavits asserted that there was no participation by Commissioner Woodside before his appointment to the Commission, either in processing Holman's applications or in the recommendations by the staff that a public hearing be held. The Court went on to say that the claims of Holman & Co. should be heard in the first instance at the administrative level, subject to judicial review when the proceeding is finally resolved.

> "The party asserting disqualification must make his record in the administrative hearing. While the scope and nature of that inquiry has never been fully delineated, it must be sufficient to allow the challenging party to introduce whatever relevant evidence he possesses bearing on disqualification since he, of course, bears the burden of proof."

SEC v. *R. A. Holman & Co.*, 323 F. 2d 284, 287 (D. C. Cir.), *cert. denied*, 375 U. S. 943 (1963).

In November 1963 petitioner requested the issuance of subpoenas *ad testificandum* upon Commissioner Woodside, several SEC staff members, and a former Commissioner, evidently with a view to procuring their testimony as to the participation of Commissioner Woodside in the investigation of petitioner before he became a Commissioner. The hearing examiner denied the request and the Commission affirmed the denial, stating that in light of the formal sworn denials by SEC officials that Commissioner Woodside did not participate while director in the investigation of petitioner, petitioner had not made an adequate showing to warrant the issuance of the subpoenas. Commissioner Woodside participated in this ruling of the Commission.

The hearings concluded on January 16, 1964. The hearing examiner handed down his recommended decision on November 4, 1964. Oral argument on review before the Commission was held on March 4, 1964. At that time Commissioner Woodside announced his decision not to be present during oral argument and not to participate in the consideration or decision of the review. The Commission published its findings and opinion on December 15, 1965, Chairman Cohen and Commissioner Woodside not participating.

Petitioner now contends that the entire proceedings were invalid because of the participation of Commissioner Woodside, or, in the alternative, because the SEC refused to permit the petitioner to make inquiry into the possible disqualification of Commissioner Woodside. As to the first point, we do not think the record before us establishes that Commissioner Woodside was disqualified within the meaning of the *Treat* case. The District of Columbia Circuit itself distinguished *Treat* from this case, on the grounds that here there was no evidence that the Commissioner sought to be disqualified had participated in an investigation of petitioner before becoming a Commissioner. In

Treat, Commissioner Cohen had been head of the Division of Corporation Finance when that division conducted an informal investigation and began a formal investigation of the Treat firm. He had been told the results of the investigation by his staff and had appeared on behalf of his division before the Commission in connection with other registrations in which the Treat firm was named as underwriter, in order to discuss the general policy to be followed with respect to the firm. In this case, there is no indication that Commissioner Woodside, before his appointment to the Commission, participated in any investigation of petitioner's activities, and public proceedings to investigate petitioner's activities were not started until September 16, 1960—two months after Woodside's appointment to the Commission. To disqualify Commissioner Woodside on the record before us would be tantamount to disqualifying from participation in an SEC adjudicatory proceeding all personnel from the Divisions of Corporation Finance and Trading and Exchanges without regard to the extent of their connection with the proceeding in its investigatory stages, and would tend to prevent the appointment to the Commission of persons who have had previous experience with its work. See 3 Loss, Securities Regulation 1877-89 (2d ed. 1961) (outlining the membership of the Commission and its staff, and pointing out that as of 1961, 14 of the 38 Commissioners had seen earlier service on the staff before their appointment to the Commission). The record here does not show that Woodside was "engaged in the performance of investigative or prosecuting functions" in any proceedings related to the present case, so as to be barred by Section 5(c) of the Administrative Procedure Act from participation in adjudicatory proceedings against the petitioner. Contrast also *American Cyanamid Co.* v. *FTC*, —— F. 2d —— (6th Cir., June 16, 1966).

Nor did the SEC unduly restrict petitioner's inquiry into the possible disqualification of Commissioner Wood-

side. If the Commission had refused to divulge anything at all about the nature of the preliminary investigation into petitioner's activities, and Woodside's role in that investigation, this would be an unfair restriction of an inquiry into possible disqualification and, if permitted, would render the *Treat* decision a meaningless admonition, easily circumvented. However, in this case the SEC has made extensive disclosures, upon sworn statements, as to the nature of the investigation and as to Woodside's role in it. The answer of the SEC in the action by petitioner for an injunction brought in the District of Columbia denied that Commissioner Woodside had participated in any informal investigation of petitioner's activities in connection with Pearson's registration statement; denied that Woodside had acquired *substantial knowledge* of the facts in issue; admitted that Commissioner Cohen, who succeeded Woodside first as Acting Director and then as Director of the Division of Corporation Finance, acquired some knowledge of the facts about petitioner's activities; pointed out that because of the large number of registrations each year, the Director of the Division of Corporation Finance is not acquainted with most of the registration statements; stated that the proceedings against petitioner stemmed from an investigation of a registration statement filed by Pearson Corporation on March 30, 1960, and that this investigation and the subsequent informal investigation of the earlier Regulation A offering and the trading in Pearson stock were under the supervision of Charles H. Eisenhart, then Assistant Director of the Division of Corporation Finance; that investigation of trading activity began in July 1960; and also stated that a formal investigation of petitioner's trading practices started on August 4, 1960. An affidavit by Charles H. Eisenhart corroborated many of these statements. In his affidavit, Eisenhart stated that he did not discuss the Pearson registration statement with the Director of the Division of Corporation Finance until after July 15th, when Woodside was no longer director.

These sworn statements on their face adequately disclosed the nature of the preliminary investigation and of Woodside's role. In light of these statements, petitioner, who had the burden of proof on the disqualification issue, as the District of Columbia Circuit recognized, 323 F. 2d at 287, was obliged either to offer evidence contradicting the sworn statements of the Commission, or to point out the inadequacy and inconsistency, if any, in the sworn statements, before he was entitled to subpoena the Commission members and staff.

2. *The Qualifications of the Hearing Examiner.*

William W. Swift was designated as the hearing examiner in the proceedings against the petitioner in October 1960. On May 15, 1962, petitioner moved to disqualify Swift, on the grounds that he had passed the mandatory retirement age and was serving at the will of the Commission. Petitioner relied in large part upon Section 11 of the Administrative Procedure Act, which provides that examiners "shall be removable by the agency in which they are employed only for good cause established and determined by the Civil Service Commission . . . after opportunity for hearing and upon the record thereof," and that examiners "shall receive compensation prescribed by the [Civil Service] Commission independently of agency recommendations or ratings." The hearing examiner and the SEC denied motion for disqualification, both on the merits and on the grounds that the motion was not timely.

Swift was first employed by the SEC as a hearing examiner in 1936. He reached the mandatory retirement age of 70 on October 31, 1957. On November 1, 1957, he received a temporary appointment for a period up to one year under the Civil Service Retirement Act, 5 U. S. C. § 2263(a), which provides:

> "Notwithstanding any other provision of law, an annuitant heretofore or hereafter retired under this

chapter shall not, by reason of his retired status, be barred from employment in any appointive position for which he is qualified. An annuitant so reemployed shall serve at the will of the appointing officer."

He was informed at the time he received notice of his temporary reappointment that "in accordance with Section 13(a) of the Civil Service Retirement Act, you may be separated at the will of the appointing officer." He has since been reappointed each year, at each time being informed that he was subject to separation at the will of the appointing officer.

We do not find it necessary to consider the merits of petitioner's motion for disqualification, since we conclude that petitioner's challenge to the qualifications of the hearing examiner was not timely, as required by § 7(a) of the Administrative Procedure Act.[1] Petitioner did not move to disqualify Swift until hearings had gone on for one and a half years and 8,000 pages of testimony had been recorded. We cannot accept the petitioner's contention that it was not aware until April 1962 that Swift was over the mandatory retirement age of 70. The hearing examiner's age must have been obvious at the beginning of the hearings in December 1960, at which time Swift was over 73. The failure to challenge Swift's qualifications on the grounds of his temporary reappointment over the retirement age at some early stage of the proceedings precludes the raising of a similar objection at this point.

Petitioner contends that the one-sentence ("The judgment is reversed") *per curiam* decision in *Riss & Co.* v.

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[1] 5 U. S. C. § 1006(a), which provides in pertinent part that the officer presiding over the taking of evidence "may at any time withdraw if he deems himself disqualified; and, upon the filing in good faith of a timely and sufficient affidavit of personal bias or disqualification of any such officer, the agency shall determine the matter as a part of the record and decision in the case."

United States, 341 U. S. 907 (1951), stands for the proposition that any challenge to the qualifications of the hearing examiner is timely so long as it is made while the hearings are still going on. We do not find the *Riss* case, which is readily distinguishable from the case at bar, authority for any proposition as broad. In *Riss*, the hearings lasted only seven days, and the common carrier did not learn until the last day of the hearings that the examiner was not an examiner appointed under § 11 of the A. P. A. 96 F. Supp. 452, 453 (W. D. Mo. 1950). Moreover, *Riss* has been qualified by the subsequent decision in *United States* v. *L. A. Trucker Lines, Inc.*, 344 U. S. 33 (1952), which held that an objection to the qualifications of the examiner would not be heard unless an "appropriate objection" to his qualifications was made and overruled during the hearings. *Cf.* also *Long Beach Fed. Sav. & Loan Ass'n* v. *Federal Home Loan Bank Bd.*, 189 F. Supp. 589, 612 (S. D. Cal. 1960), *rev'd on other grounds*, 295 F. 2d 403 (9th Cir. 1961).

3. *Other Alleged Procedural Irregularities.*

Petitioner asserts that other procedural irregularities vitiated and invalidated the proceedings against it. It first contends that it was improperly denied access to certain ex parte communications from the SEC staff to the SEC with respect to the consolidation of the proceedings against petitioner and the amendment to include the Precise stock as well as the Pearson stock. However, we agree with the Commission that it was not required to divulge the communications in question which merely concerned the nature of the proposed proceedings. Lack of access to the communications in no way affected petitioner's ability to defend himself. Nor were the communications the ex parte communications forbidden by § 5(c) of the Administrative Procedure Act, since no "adjudication" was yet under way, see § 2(d) of the act, and since § 5(c) does not apply "to the agency or any member or members of the body comprising the agency." See *Amos Treat & Co.* v. *SEC*, 306 F. 2d

260, 266 (D. C. Cir. 1962) (the exclusionary phrase just quoted permits "a Commissioner to participate in a decision of the Commission that an investigation go forward and even that charges be filed to the end that an adjudicatory proceeding might be initiated"). See also H. R. Rep. No. 1980, 79th Cong., 2d Sess. 31 (1946), S. Rep. No. 752, 79th Cong., 1st Sess. 18 (1945).

Nor was it error for the hearing examiner to prevent petitioner from establishing that other broker-dealers were engaged in transactions in Pearson and Precise stock during the periods in question on certain days. The SEC conceded that such trading went on. It is hard to see how such testimony would be other than cumulative, if not irrelevant, since proof of such trading did not tend to refute the charges against petitioner.

As to the entries made on petitioner's books by Klapper, a staff witness who was petitioner's cashier at the time the entries were made, it is hard to see how they were a "statement" which the SEC was required to divulge under the *Jencks* case, see *NLRB* v. *Adhesive Products Corp.*, 258 F. 2d 403 (2d Cir. 1958). Nor was it prejudicial error for the SEC to rule with respect to a statement of a witness obtained during investigation that petitioner's counsel could examine the statement only in the presence of the hearing examiner or of a staff member and could not make copies of it, though he could examine it at length and ask for a recess to examine it. This ruling did not unduly impair counsel's ability to use prior statements of witnesses for purposes of impeachment—the rationale underlying *Jencks* v. *United States*, 353 U. S. 657 (1957).

Affirmed.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 418—September Term, 1965.

(Argued June 21, 1966 Decided September 21, 1966.)

Docket No. 30039

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

—v.—

R. A. HOLMAN & Co., INC., RICHARD A. HOLMAN and IRVING BIENENSTOCK a/k/a IRVING BURNS,
Defendants-Appellants,

—and—

BEN F. HARBURGER and HENRY N. BUDOFF,
Defendants.

Before:

WATERMAN, MOORE, and KAUFMAN,
Circuit Judges.

Appeal from an order of the District Court for the Southern District of New York, Fred L. Wham,* *Judge,* permanently enjoining the appellants and other named defendants from specified violations of Section 17(a) of the Securities Act of 1933 and Section 15(c)(1) of the Securities Exchange Act of 1934, 15 U. S. C. §§ 77q(a), 78o(c)(1). Affirmed.

SIDNEY P. HOWELL, JR., New York, N. Y. (Marie V. Driscoll, Richard A. Holman, and Rogers, Hoge & Hills, all of New York, N. Y., with him on the brief), *for the appellants.*

DAVID FERBER, Solicitor, Securities and Exchange Commission, Washington, D. C. (Philip A.

* Senior District Judge, Seventh Circuit, sitting by designation.

Loomis, General Counsel, and Martin D. Newman, Attorney, both of the Securities and Exchange Commission, Washington, D. C., with him on the brief), *for the appellee.*

MOORE, *Circuit Judge*:

The case at bar was commenced on March 15, 1963, by the filing in the District Court for the Southern District of New York of a complaint by the Securities and Exchange Commission (SEC), charging that R. A. Holman & Co., Inc., a New York securities firm; Richard A. Holman, its president; and three salesmen of the firm, Irving Bienenstock (also known as Irving Burns), Ben F. Harburger, and Henry Nathan Budoff; had violated § 17a of the Securities Act of 1933 [15 U. S. C. § 77q(a)] and § 15(c)(1) of the Securities Exchange Act of 1934 [15 U. S. C. § 78o (c)(1)], in connection with the offer and sale to the public of stock in Pearson Corporation during the preceding six months. The relief requested was an injunction against further violations. After trial without a jury, the trial judge adopted as his own findings of fact, conclusions of law, and judgment proposed by the SEC, and entered a permanent injunction against each of the defendants except Budoff, who had consented to the entry of a separate permanent injunction against him before trial. From this judgment R. A. Holman & Co., Holman, and Bienenstock appeal.

The basic question on appeal is the sufficiency of the evidence before the trial court that appellants had violated the cited statutory provisions, which proscribed, in connection with the purchase, offer, or sale of any securities which involves the use of the mails or of any instrumentality of interstate commerce, the employment of any fraudulent or deceptive device or contrivance, and the obtaining of money or property "by means of any untrue statement of a material fact or any omission to state a material fact

necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . ."

Appellants also challenge the verbatim adoption by the trial court of the SEC's proposed findings and conclusions. Although this practice has been criticized, e.g., *Roberts* v. *Ross,* 344 F. 2d 747 (3d Cir. 1965); see *United States* v. *El Paso Natural Gas Co.,* 376 U. S. 651, 656-57 (1964), it is not grounds for reversal, and the findings of fact and conclusions of law thus adopted will stand if supported by the evidence. See *United States* v. *El Paso Natural Gas Co., supra.* For reasons discussed below, we conclude that the evidence before the trial court justified most, if not all, of his findings, and warranted the issuance of the injunction under appeal.

We should state at the outset that Pearson Corporation, whose stock appellants sold, was not, in contrast to the companies involved in many securities fraud cases, a "fly-by-night" company. Pearson, a Rhode Island corporation, produced and still produces an outstanding line of fiberglass boats. Its sales had grown rapidly since its organization in 1956. On January 1, 1961, the company merged with the aluminum-boat manufacturer Grumman Boats, Inc., a subsidiary of Grumman Aircraft Engineering Corp. The merger resulted in Grumman Aircraft's ownership of over 61% of the outstanding capital stock of Pearson. Around this time, Grumman Aircraft helped Pearson obtain much-needed long-term financing. Although Pearson suffered a net operating loss of $272,003 in 1961, it had shown modest profits in 1958, 1959 and 1960. A return to profitable operation was a distinct possibility.

We may also state at the outset that we are not convinced that all of the statements and omissions described by the trial court were materially misleading under the circumstances in which they were made (or not made). For example, appellants never disclosed that some of the

Pearson stock they were selling had been acquired for investment and not with a view towards distribution to others. The shares in question had been obtained in 1960 through the exercise by Holman & Co. of warrants it had been given in connection with a 1959 offering of Pearson stock under Regulation A. See *R.A. Holman & Co.* v. *SEC*, —— F. 2d ——, ——, decided this day. At the time Holman & Co. exercised the warrants, it furnished a certificate that it was acquiring the shares for investment and not with a view to resale. The SEC maintains, and the trial court held, that appellants should have told their customers not only that Holman & Co. was acting as "principal" in selling Pearson stock—a disclosure appellants did make—but also that Holman & Co. had taken the stock for investment. The SEC maintains that a prospective purchaser might well want to know why a stock originally taken for investment was now being sold. We do not believe that this omission was materially misleading. Holman & Co. had already disclosed that it was selling for its own account. To disclose that it had taken the stock "for investment" a number of years before, since the warrant contract required that a certificate of investment purpose be given to the company, would have added little to what the customer had already been told. Moreover, the SEC had never previously suggested that any such disclosure be made. Cf. *NLRB* v. *Majestic Weaving Co.*, 355 F. 2d 854 (2d Cir. 1966).

Nor was it more than mildly misleading for Holman & Co. to report in its market letter of January 1962 that it estimated Pearson's sales in 1961 to be "between $4 million and $5 million." The market letter was prepared before final figures for the year were available, and the discrepancy between the figures estimated and the final sales figure of $3,874,870 is not very large. It is true, however, that the letter was overly optimistic in portraying a large jump over 1960 sales of $3,086,972, and that the letter should not have been sent out without qualification once the final figures became available.

Apart from these few instances, the record more than adequately supports the trial court's findings as to the existence of materially misleading statements and omissions. Several examples may be briefly summarized.

The market letter of January 1962, sent out to customers even after September 1962, spoke of Pearson's "financial strength," pointing in particular to "a healthy current asset-liability ratio of 2.68 to 1." It neglected to point out that much of the "health" of this ratio resulted from a transaction in February 1961, by means of which a current liability in the amount of $625,000 was changed to a long-term debt on the books of the company.

A number of verbal representations made by appellant Bienenstock were also materially misleading. Several customers testified that Bienenstock told them that there was only a limited supply of Pearson stock available. Appellants contend that these statements were correct, since they were no more than statements by Bienenstock that he had authority only to issue a certain amount of shares at the price under discussion, which was both true and apparently in accord with standard over-the-counter practice. This contention is refuted by the testimony of the customers, which makes clear that Bienenstock was talking about a limited supply at any price—which was not true. It was also materially misleading and untrue for Bienenstock to tell a customer, as he did, that the reason Pearson stock had not gone up was because a large shareholder had dumped 10,000 shares on the market. It was true that a large Pearson shareholder was selling at the time, but he had sold only 1,090 shares. Bienenstock also predicted that Grumman Aircraft would soon participate more closely in the affairs of Pearson, in which it already had an interest, although at the time these predictions were made Grumman Aircraft had formulated no such plans; and they indicated—without any basis in fact—that Grumman would try to get Navy contracts for Pearson. Bienenstock also said

that the stock would rise to specified prices, which he named (predicting to some customers that the price would more than double in a matter of three months), partly as a result of interest which would be generated in the stock by the forthcoming 1963 New York Boat Show. It is true that Pearson stock often appeared at near-term high levels at the start of the Boat Show in previous years, but it is also true that in 1961 and 1962, the price of the stock was less at the close of the Boat Show than it had been at the beginning. It was materially misleading to tell prospective purchasers of the former phenomenon, without also informing them of the latter. Moreover, the specific price predictions made by Bienenstock during his telephone conversations were themselves violative of the antifraud provisions of the federal securities laws, since no adequate basis existed for representations so optimistic. See *Berko* v. *SEC*, 216 F. 2d 137, 143 (2d Cir. 1963).

Finally, neither in the material mailed out nor in telephone conversations with prospective customers did Holman or his salesmen disclose that Pearson had suffered a net loss of $272,000 before taxes in 1961. Appellants urge that the material they mailed out, if carefully read, would have revealed the existence of a loss of some size in that year, since it mentioned the existence of a loss carry-forward, and a note to an income statement disclosed that had it not been for the loss carry-forward federal income tax liability would have amounted to $84,407. However, in order to deduce from this that there was a significant loss in 1961, one would have to join the statement about the loss carry-over with statements in Holman & Co.'s market letter which indicated that in past years (other than 1961), the firm had shown a profit; and even if one were astute enough to do all this, and to calculate the minimum size of the loss from the fact that the loss carry-over was large enough to eliminate income tax liability for the first half of 1962, one would have known only that the loss was at

least of the order of $163,000—not that it amounted to $272,000. The size of the 1961 loss was unquestionably a fact to which "a reasonable man would attach importance . . . in determining his choice of action in the transaction in question," namely, whether or not it was advisable to buy Pearson stock. *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir.), *cert. denied*, 382 U. S. 811 (1965).

The picture which emerges from the record, in short, is of a high-pressure sales campaign relying in substantial part on materially misleading statements and omissions. The trial court was justified in enjoining further violations of the federal securities laws, and the judgment below accordingly is affirmed.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

September Term, 1965.

(Petitions for Rehearing submitted October 20, 1966
Decided May 15, 1967.)

Docket No. 30039

Cal. No. 418

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

—against—

R. A. HOLMAN & Co., INC., RICHARD A. HOLMAN and IRVING BIENENSTOCK a/k/a IRVING BURNS,
Defendant-Appellants.

Docket No. 30276

Cal. No. 419

R. A. HOLMAN & Co., INC.,
Petitioner,

—against—

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Before:

WATERMAN, MOORE and KAUFMAN,
Circuit Judges.

Petitions for rehearing. Granted in No. 30276 and former opinion reported at 366 F. 2d 446 is amended in conformity with this opinion.

Denied in No. 30039.

SIDNEY P. HOWELL, JR. (Rogers, Hoge & Hills, New York, N. Y.; Arnold & Porter, Washington, D. C.; and Richard A. Holman, New York, N. Y., on the brief), *for petitioners.*

PER CURIAM:

The opinions of this Court in the above entitled proceedings were filed on September 21, 1966. See *SEC* v. *R. A. Holman & Co.*, 366 F. 2d 456 (No. 30039) and *R. A. Holman & Co.* v. *SEC*, 366 F. 2d 446 (No. 30276). R. A. Holman & Co., Inc., Richard A. Holman and Irving Bienenstock, as defendants-appellants in No. 30039 and R. A. Holman & Co., Inc., as petitioner in No. 30276, now petition for rehearings of the appeals in said cases. We grant the petition for rehearing in No. 30276 and amend our former opinion in conformity with this opinion. The petition for rehearing in No. 30039 is denied, as we adhere to our former opinion.

The most serious allegations of factual error, contained in R. A. Holman & Co.'s rehearing petition in No. 30276, pertain to that part of the Court's opinion that deals with the offer and sale of Precise stock. 366 F. 2d at 448-50. We there upheld the Commission's findings that petitioner (1) purchased Precise stock while still participating in its distribution in violation of Rule 10b-6; (2) engaged in activities designed to induce or effect the purchase or sale of Precise stock without disclosing the fact of its control of Precise in violation of Rule 15c1-5; and (3) made misleading and unjustifiable representations to customers as to the value of Precise stock.

Petitioner claims that the Court confused the "unit" of Precise stock offered to the public (consisting of one share of common stock and one share of preferred convertible into four shares of common) with a "share" of Precise common, equivalent to only 1/5 the value of the "unit." Thus with respect to the Kabian transaction, petitioner complains that it was misleading for this Court to state that 13,000 *units* were allocated to Mr. Kabian's account on December 30, 1958 on a delayed delivery basis, and that after Mr. Kabian cancelled, Richard A. Holman, petitioner's president, subsequently put 10,000 *shares* of Precise common into petitioner's trading account and sold them to the

public. Petitioner asks whether we fully realized that after the sale of 10,000 *shares* there were still 55,000[1] (or its equivalent) shares of common in petitioner's account left over from the cancelled Kabian order. We were not under any basic misconception as to the distinction between shares or units with respect to this transaction; certainly the purchase and sale of 10,000 shares by petitioner during "distribution" is enough to establish a serious violation of Rule 10b-6. In the next paragraph, 366 F. 2d at 449, however, we did refer to 33,200 *shares* of stock being sold by December 31, 1958 when the reference should have been to 33,200 *units*. This appears to have been a mere slip in view of the correct reference to 33,200 *units* earlier on the same page. Thus, while the mistake is noted and corrected, it did not undermine the factual basis for the Court's finding against petitioner with respect to the Kabian transaction.

The factual basis for our conclusion that Holman was "controlling" Precise on December 9, 1958, is also challenged. Prior to the public offering, 130,000 shares of Precise common stock were outstanding—55,000 in the name of Byron, 75,000 in the name of Silber. This Court stated that by December 9, 1958 (the date Holman bought Silber's 75,000 shares) 15,220 *shares* of the new offering had been sold so that the total shares of common stock then outstanding were 145,220, thus leaving Holman holding a "majority" of the stock. This might be technically correct, but we failed to mention that 15,220 shares of preferred stock (equivalent to 60,880 shares of common) were, of course, issued along with the 15,220 common as part of each offering *unit*. Holman was thus a "majority" holder of Precise

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[1] This figure is presumably calculated by taking the 13,000 units sold to Kabian, namely, 13,000 common and 13,000 preferred convertible into common at the ratio of 4 to 1, and then assuming conversion resulting in 52,000 shares or a total of 65,000 shares of common. There is no proof that any such conversion had taken place.

common only if the owners of the preferred had not by December 9th exercised some of their conversion rights of which there is no proof. However, it is generally recognized that to "control" a corporation within the meaning of Rule 15c1-5, 17 C. F. R. § 240.15c1-5, it is not necessary to own a majority of the corporation's voting stock. See Loss, Securities Regulation, 765, 770-83 (2d ed. 1961). Even if Holman did not own a majority of Precise common stock on December 9, 1958, he certainly was the dominant shareholder exercising effective control over the corporation and his failure to disclose such fact violated Rule 15c1-5.

In upholding the Commission's findings with respect to petitioner's misrepresentations as to the value of Precise stock, we referred to a "sharp drop" in the market immediately after the public offering was closed uncompleted. In fact, as petitioner points out, there was no drop as the offering price had been $5 per *unit* and the after market price of the common fluctuated between 1 and 1⅞ per *share* (the equivalent of 5 to 9⅜ per *unit*). But, of course, the company did go into bankruptcy in November, 1959. Our error should be corrected, but does not dictate a different conclusion with respect to the misrepresentation charge. The fact remains that during the relevant times when petitioner was actively recommending Precise stock to its customers, Precise was in a precarious financial position and petitioner's salesmen knew it but chose not to pass on the information to their customers. That the investment did not prove worthless until several months later and that during part of that time the customers could have sold at a profit, does not justify the initial misrepresentation.

Petitioner's other arguments advanced in its petition for rehearing do not pertain to this Court's understanding of the underlying facts of the controversy but criticize our conclusions of law on several material points. We have reviewed those conclusions and reaffirm them. Our affirmances in No. 30276 and No. 30039 stand.

APPENDIX D

5 U.S.C. § 1004(c) provides in relevant part:

"No officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review pursuant to section 1007 of this title except as witness or counsel in public proceedings."

5 U.S.C. § 1006(a) provides in relevant part:

"The functions of all presiding officers and of officers participating in decisions in conformity with section 1007 of this title shall be conducted in an impartial manner. Any such officer may at any time withdraw if he deems himself disqualified; and, upon the filing in good faith of a timely and sufficient affidavit of personal bias or disqualification of any such officer, the agency shall determine the matter as a part of the record and decision in the case."

5 U.S.C. § 1010 provides:

"Subject to the civil-service and other laws to the extent not inconsistent with this chapter, there shall be appointed by and for each agency as many qualified and competent examiners as may be necessary for proceedings pursuant to sections 1006 and 1007 of this title, who shall be assigned to cases in rotation so far as practicable and shall perform no duties inconsistent with their duties and responsibilities as examiners. Examiners shall be removable by the agency in which they are employed only for good cause established and determined by the Civil Service Commission (hereinafter called the Commission) after opportunity for hearing and upon the record thereof. Examiners shall receive compensation prescribed by the Commission in-

dependently of agency recommendations or ratings and in accordance with the Classification Act of 1949, except that the provisions of paragraphs (2) and (3) of subsection (b) of section 669 of this title, shall not be applicable. Agencies occasionally or temporarily insufficiently staffed may utilize examiners selected by the Commission from and with the consent of other agencies. For the purposes of this section, the Commission is authorized to make investigations, require reports by agencies, issue reports, including an annual report to the Congress, promulgate rules, appoint such advisory committees as may be deemed necessary, recommend legislation, subpena witnesses or records, and pay witness fees as established for the United States courts."

15 U.S.C. § 77c(b) provides:

"The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $300,000."

15 U.S.C. § 77h(b) provides:

"If it appears to the Commission that a registration statement is on its face incomplete or inaccurate in any material respect, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice not later than ten days after the filing of

the registration statement, and opportunity for hearing (at a time fixed by the Commission) within ten days after such notice by personal service or the sending of such telegraphic notice, issue an order prior to the effective date of registration refusing to permit such statement to become effective until it has been amended in accordance with such order. When such statement has been amended in accordance with such order the Commission shall so declare and the registration shall become effective at the time provided in subsection (a) or whichever date is the later."

15 U.S.C. § 77h(d) provides:

"If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and after opportunity for hearing (at a time fixed by the Commission) within fifteen days after such notice by personal service or the sending of such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order, the Commission shall so declare and thereupon the stop order shall cease to be effective."

15 U.S.C. § 77q(a) provides:

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

15 U.S.C. § 78o(b) provides in relevant part:

"A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration, which shall contain such information in such detail as to such broker or dealer and any persons associated with such broker or dealer as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. Except as hereinafter provided, such registration shall become effective thirty days after the receipt of such application by the Commission or within such shorter period of time as the Commission may determine."

15 U.S.C. § 78o(c)(1) provides:

"No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent."

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 614

R. A. HOLMAN & CO., INC., AND RICHARD A. HOLMAN,
PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (Pet. 1a, 17a, 24a)[1] are reported at 366 F. 2d 446 and 456, and 377 F. 2d 665. The opinion and orders of the district court and of the Commission are unreported.

JURISDICTION

The judgments of the court of appeals were entered on September 21, 1966, and were re-affirmed on

[1] We follow petitioner in referring to the transcript of the administrative proceeding as "R.", the printed Appendix for Petitioner in the court of appeals in that proceeding as "Pet. App.", and the printed Appendix for Appellants in the court of appeals in the injunctive proceeding as "Apps. App.". We refer to the appendix to the petition for certiorari as "Pet. —a."

rehearing on May 15, 1967. On July 28, 1967, Mr. Justice White granted an extension of time to file a petition for a writ of certiorari until September 13, 1967, and the petition was filed on that day. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether no reasonable basis existed for securities salesmen to predict to prospective customers large price increases in the stock they were distributing.

2. Whether a decision of the Securities and Exchange Commission, in which three commissioners participated, is invalid because another commissioner had once as a staff official had purely nominal responsibility for an informal inquiry that led to institution of the administrative proceeding and participated as a commissioner in issuing the order instituting it and in several subsequent procedural rulings, although he did not participate in the decision.

3. Whether, in the special circumstances of this case, the fact that the hearing examiner had passed normal retirement age and, in accordance with the Civil Service Retirement Act, was retained at the Commission's pleasure requires the invalidation of the Commission's decision.

STATUTES AND RULE INVOLVED

The pertinent provisions are Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(c)(1), and Rule 15c1–2 thereunder, 17 C.F.R. § 240.15c1–2, and Sections 5(c), 7(a) and 11 of

the Administrative Procedure Act, 5 U.S.C. 1004 (c), 1006(a) and 1010 (now codified in 5 U.S.C. 554, 556, 1305, 3105, 5362 and 7521). Except for Rule 15c1–2 (printed in the Appendix, *infra,* p. 19), all of these provisions are printed in Appendix D to the petition (pp. 28a–31a).

STATEMENT

The petition seeks review of two different decisions of the court of appeals.

One affirmed an order of the Commission which revoked the registration under the Securities Exchange Act of R. A. Holman & Co., Inc. ("Holman, Inc."), as a broker and dealer, expelled it from membership in the National Association of Securities Dealers, Inc., and made permanent a previous suspension of a conditional exemption from the registration provisions of the Securities Act for a 1959 offering by Holman, Inc., of securities of Pearson Corporation. With respect to that offering, as the court of appeals noted, the Commission found that Holman, Inc., "together with or aided and abetted by [petitioner Richard A.] Holman, willfully violated the anti-fraud provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the (Securities) Exchange Act and Rules 17 CFR 240.10b–5, 10b–6, and 15c1–2 thereunder" (Pet. App. 10a–11a). The Commission also found that, in another public distribution of securities some months earlier, involving stock of Precise Development Corporation, Holman, Inc., "aided and abetted by Holman," had violated these same provisions (Pet. App. 20a), and the Commission held that this "extensive fraudulent

activity in the offer and sale of Precise Stock in itself warrants the sanction imposed" (Pet. App. 28a).[2]

The other order from which review is sought affirmed an order of the United States District Court for the Southern District of New York permanently enjoining Holman, Inc., Holman, and others from specified fraudulent activity in a sale of a block of stock of Pearson Corporation in 1962–1963. The only connections between this case and the administrative proceeding are (a) that petitioners were involved in both cases; (b) that there were violations found in each relating to sales of Pearson stock (although the administrative proceeding related to a distribution occurring three years before the distribution enjoined by the district court); (c) that, in each case, stock sales were induced by means of false and misleading statements, extravagant predictions without reasonable basis, and nondisclosure of material information;[3]

[2] Petitioner Holman did not seek review of the Commission's administrative determination.

[3] Thus, in the administrative proceeding, the Commission found, *e.g.*, with respect to the sale of Precise stock that one salesman selling the stock at 1⅛ told purchasers that it would double or triple in value within a short time and would rise to 4 or 5 within about 90 days. Another salesman selling the stock at 1⅞ told his customers that Precise would go to 3 or 4 in a month or two, would be "around" $4 a share when a "public offering" was made, would "probably have a top value of $9 or $10 a share," had good prospects and a promising future with expected sales of about $1,000,000, and that a customer should order 2,000 shares in order to be sure of getting 1,000 shares (Pet. App. 13a). These representations were made in January and May of 1959, and by November of that year Precise had filed a petition for an arrangement under Chapter XI of the Bankruptcy Act (Pet. App. 13a–14a, 16a). In

and (d) that, as petitioners suggested to the court below, the affirmance of either order could result in the other becoming largely moot.[4]

The Administrative Proceeding.—In the spring and summer of 1960, a registration statement (which was subsequently withdrawn) for the sale of an issue of Pearson stock naming Holman, Inc., as the proposed underwriter was being examined in the Commission's Division of Corporation Finance. Examination of the statement led to questions respecting an offering the previous year of Pearson stock through Holman, Inc., purportedly pursuant to a conditional exemption from registration. On August 4, 1960, the Commission issued a formal order of investigation relating to Holman, Inc.'s activities with respect to that earlier offering. On September 16, 1960, the Commission temporarily suspended the conditional exemption. This led to a hearing to determine whether the suspension should become permanent. That proceeding was consolidated

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the injunctive proceedings, the district court found the defendants sold the stock through "boiler-room" practices (Apps. App. 407a, 416a, 422a). Among the materially misleading statements made to prospects noted by the court of appeals were that "there was only a limited supply of Pearson stock available" and that the stock "would rise to specified prices"; one salesman predicted that it "would more than double in a matter of three months" (Pet. 21a–22a).

[4] Counsel for petitioner stated to the court of appeals that if they should be unsuccessful in their review of the Commission's decision in the administrative action, the issues in the injunctive action would be "academic"; "[o]n the other hand," if the injunction were to stand, it could be the basis for a "new revocation proceeding." Affidavit (p. 6) of Sidney P. Howell, Jr., sworn to January 18, 1966, in support of motion for extension of time to file appellants' brief in injunction action.

with a proceeding instituted by the Commission on September 26, 1960, to determine whether the broker-dealer registration of petitioner should be revoked and whether there should be other sanctions against petitioner by reason of its activities in connection with the 1959 Pearson offering. The order for proceeding was amended on November 15, 1960, to allege additional violations of the federal securities laws with respect to an offering by petitioner commencing in October 1958 of the stock of Precise Development Company, the first public distribution of securities by petitioner.

On December 15, 1965, the Commission issued its findings and opinion and entered its order concluding the administrative proceedings—the order which is here sought to be reviewed (Pet. App. 3a–32a). The petition does not question the Commission's findings, affirmed by the court of appeals, of repeated and serious violations of the securities laws by petitioner, nor does it suggest that the sanctions applied by the Commission were not in the public interest. Instead it asks this court to consider two procedural issues: one relating to the participation in various preliminary and procedural orders by a commissioner who, prior to July 15, 1960, had headed the staff division that was processing the subsequently-withdrawn Pearson registration statement but who did not participate in the ultimate determination of the Commission embodied in the Commission's order sought to be reviewed; the other, which the court of appeals did not reach because it agreed with the Commission that it was raised too late (Pet. App. 24a, 100a, Pet. 14a),

relating to the Commission's use of a hearing examiner who had passed the normal retirement age.

The Injunctive Proceeding.—During the pendency of the administrative proceeding petitioners were continuing to sell securities. At a time when they had succeeded in staying the administrative proceeding for a substantial period of time,[5] the Commission discovered that petitioners were engaged in selling Pearson stock in what appeared to be a fraudulent manner, and, on March 15, 1963, it sought to enjoin these activities. After a trial lasting several days, it was found that, for some months preceding the filing of the Commission's complaint, petitioners had been selling Pearson stock through an intensive long-distance telephone campaign, which included numerous material untruths and half truths and omissions to state facts necessary to make the statements not materially misleading. The telephone calls had been preceded by a market letter which was also found to have been materially misleading.

While the court of appeals was "not convinced that all of the statements and omissions described by the trial court were materially misleading * * *" (some being merely, in the court's view, "mildly misleading") (Pet. 19a, 20a), it concluded that, apart from the few instances it had specified, "the record more

[5] Petitioner had obtained a preliminary injunction in July 1962, which was reversed on June 13, 1963. *Securities and Exchange Commission* v. *R. A. Holman & Co., Inc.*, 323 F. 2d 284 (C.A.D.C.). The Commission proceeding was in abeyance until after denial of certiorari on December 9, 1963. 375 U.S. 943.

than adequately supports the trial court's findings as to the existence of materially misleading statements and omissions" (Pet. 21a). These findings of the district court included a finding that the market letter "stated that 'working capital [of Pearson] jumped from a minus figure of $17,418 to a healthy entry in the plus column of $1,284,856' " without showing that this was caused by transforming a current liability of $625,000 into a long-term debt (Apps. App. 411a, 422a); that one of Holman, Inc.'s salesmen told several potential investors of a proposed merger between Pearson and "Grumman," without disclosing that this was not "Grumman Aircraft," for whose stock there was a market, but was the "newly-created Grumman Allied" (Apps. App. 407a, 422a); and that one of the salesmen, who was selling Pearson stock at prices no higher than 4½ dollars per share, advised investors that it would shortly more than double in value and that he "could 'guarantee' that Pearson stock would be selling at $10 by Christmas" and that the same salesman later answered an inquiry as to why the stock had not risen by stating that 10,000 shares had been "dumped" on the market—a statement for which there was no basis in fact (Apps. App. 408a, 410a, 422a). Additional findings of the district court, held by the court of appeals to be adequately supported by the record, related to misrepresentations as to how "hard to come by" was the Pearson stock and how it was obtainable only if the investor "acted quickly" (Apps. App. 409a, 410a, 422a).

1. The issue claimed by petitioners to arise from the injunctive proceeding is factually not present. They contend that the courts below determined that predictions of future increases in stock prices are *per se* fraudulent, contrary to the holding in *Berko* v. *Securities and Exchange Commission*, 297 F. 2d 116 (*Berko I*), of the same court of appeals that such predictions are fraudulent only if shown to be without reasonable basis. However, the findings of the district court that the court of appeals found to be fully substantiated by the record establish numerous violations which justify the injunction quite apart from the testimony with respect to the salesmen's predictions of price increases.[6]

Moreover, the district court expressly found that "[t]here was no basis in fact for any of these predictions" (Apps. App. 408a, 422a). Without record citation, the petition purportedly summarizes evidence from which the petitioners would have this Court find that there was a reasonable basis for such

[6] The petition (p. 15) appears to suggest that the reason for Judge Bonsal's refusal to grant a preliminary injunction was that he questioned the Commission's allegations of violations, which had been "vigorously contested by petitioners." On the contrary, Judge Bonsal stated: "On the record here it is clear to the Court that high pressure methods were used by the defendants and that the salesmen named did make statements which would tend to mislead the public." (Apps. App. 34b.) The preliminary injunction was denied because Judge Bonsal believed it was unlikely, "pending a trial for a permanent injunction", that petitioners would engage in violations (Apps. App. 38b).

predictions (Pet. 16).[7] But, even assuming the truth of the evidence introduced by petitioners, the determination of the court below that it constituted no basis in fact for the predictions made was certainly a reasonable one in the light of the entire record. For example, the petition points out that the stock "had risen" at the start of previous annual New York Boat Shows. As the district court noted, however, investors who had been told "that it was a good time to buy Pearson stock in view of the approaching opening of the Boat Show * * * were not told that although the market price of Pearson stock had risen during the 1961 and 1962 New York Boat Shows, the market price of the stock was lower at the close of each boat show than it had been at the beginning" (Apps. App. 409a).

While petitioners purport to find a parallel between this case and *Berko I, supra,* and its companion case, *Kahn* v. *Securities and Exchange Commission,* 297 F. 2d 112 (C.A. 2), the case more closely parallels

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[7] The statement in the petition (p. 16) that "[t]he SEC introduced evidence that a salesman had offered investors Pearson stock at $4½ a share" suggests that these predictions were all made when the stock was selling at that high a price. While the district court found that the predictions that Pearson stock would go to various prices ranging from $7 per share to $12 per share were made when that stock was being sold "at prices *not higher* than $4½ per share" (Apps. App. 408a, emphasis added), the witness to whom the salesman guaranteed the stock would reach $10 by Christmas (Statement, *supra,* p. 8) purchased 100 shares in October at 3¾ (Apps. App. 74a–75a, 84a) on the basis of that representation. Another investor testified that he was told the stock would probably go up to $7 or $8 per share when he purchased 100 shares at 3⅜ (Apps. App. 15a–16a).

the decision of the court of appeals in affirming the Commission's action after the remand in those cases. See *Berko* v. *Securities and Exchange Commission*, 316 F. 2d 137 (*Berko II*), where it was made clear that a salesman, knowing of misleading brochures sent to customers, violates the securities laws when he makes optimistic price predictions without advising the prospective purchaser of the errors in the brochure. Here, the trial court held that petitioners' practices were those which the court of appeals had described in the *Berko II* case as "boiler-room" type, and, as noted, found that the brochures previously sent to investors had been materially misleading and that the salesmen had made additional untruthful statements that were also materially misleading.

2. Petitioner attacks the validity of the Commission's decision in the administrative proceeding on the basis of former Commissioner Woodside's exercise of "adjudicative responsibilities" in the proceeding (Pet. 5). We submit, however, that Commissioner Woodside's determination not to participate in the final decision[8] cured any possible error in his partici-

[8] Commissioner Woodside explained his reasons for not participating as follows (R. 16247):

> I have determined not to be present during the oral argument nor to participate in the Commission's consideration or decision in this proceeding. I have made this determination in view of the charges made by respondent R. A. Holman & Company, Inc., that I am disqualified because I had been Director of the Division of Corporation Finance at the time a registration statement was filed, which was subsequently withdrawn, naming Holman as underwriter. I wish to emphasize that I do not believe it is improper or unlawful for me to participate in this case and do not consider myself disqualified for any reason from

pation in the determination that the proceeding be instituted and in several subsequent procedural rulings. Even when a member of an agency has participated in a final decision and is subsequently found to have been disqualified, the accepted remedy is for the remaining members to decide the matter on the same record. *Berkshire Knitting Mills* v. *National Labor Relations Board*, 139 F. 2d 134 (C.A. 3);[9] *Texaco, Inc.* v. *Federal Trade Commission*, 336 F. 2d 754, 760 (C.A.D.C.),[10] vacated on other grounds, 381 U.S. 739.

In all events, the Commission held that the administrative sanctions it had imposed were fully warranted solely by petitioner's fraudulent conduct with respect to the Precise offering (Pet. App. 28a) and the court of appeals specifically held with respect to

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so doing. There is, however, a quorum of the Commission available for rendering a decision in my absence. In addition to my personal reluctance to participate in a decision where my qualification to do so has been challenged, and in view of the extensive period of time during which this proceeding has been pending, I desire to avoid providing a possible further occasion for delay.

[9] This decision sustained the Labor Board's denial of a hearing *de novo* (*In the matter of Berkshire Knitting Mills*, 37 N.L.R.B. 926, 927), after it had been held that, if a Labor Board member who participated in the agency's final determination should be disqualified, "the entire case" should be "reconsidered by the members not so disqualified." *Berkshire Employees Ass'n, etc.* v. *National Labor Relations Board*, 121 F. 2d 235, 239 (C.A. 3).

[10] The opinion of Judge Washington, concurring in part and dissenting in part, makes clear that the "de novo consideration" there ordered to be given the matter by non-disqualified commissioners was "a de novo consideration of the record." 336 F. 2d at 764. Initiation of a wholly new administrative proceeding was not required.

"the offer and sale of Precise stock" and "[t]he evidence adduced supports the SEC's conclusion that R. A. Holman, the president and sole stockholder of R. A. Holman & Co., and R. A. Holman & Co. were guilty of a number of willful violations of the Securities Act and of the Securities Exchange Act" (Pet. 2a–3a). Since it has never been suggested that Commissioner Woodside was disqualified with respect to the charges relating to the Precise offering, his alleged disqualification with respect to the Pearson offering is immaterial.

In any event, petitioners have not shown any basis for disqualifying Commissioner Woodside. The entire basis for his alleged disqualification is the fact that he was Director of the Commission's Division of Corporation Finance for several months while the subsequently-withdrawn Pearson registration statement was under examination in that Division, in the course of which inquiries were raised respecting the earlier Pearson offering that became a subject of the administrative proceeding. The inquiries led to a formal order of investigation after Mr. Woodside had become a member of the Commission and this, in turn, preceded the institution of the administrative proceeding. The record makes clear that while a member of the staff his only connection with the investigation was a formal supervisory authority over all activities of the Division; he had no personal knowledge of the inquiries being made. In addition to the affidavit of the Assistant Director who had charge of the matter that he never consulted Mr. Woodside as Director about it, the Commission itself filed an answer

denying the petitioner's allegations that while Mr. Woodside was Director of the Division he had "acquired substantial knowledge of the facts in issue" (Pet. App. 7b–8b, 64b). This answer was verified by the Secretary of the Commission on its behalf and on behalf of its members, including Commissioner Woodside, after the Commission had "duly considered" the pleadings (Pet. App. 135b–136b).[11]

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[11] The statement, quoted in the petition (p. 11), of the Court of Appeals of the District of Columbia Circuit in *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 323 F. 2d 284, 287, was made on a record containing the affidavit of former counsel for petitioner that he was confident that examination, *inter alia*, of his "own files and records and those of Pearson Corporation would make * * * clearer" the relationship between Mr. Woodside and the investigation and that of his "own knowledge" there were "many other respects in which the Commission's answer" was "inaccurate" (Pet. App. 134b). That affiant was not subsequently called by petitioner to testify in the administrative proceeding nor was any other evidence introduced by petitioner to show any connection between Mr. Woodside, when he was Director of the Division of Corporation Finance, and the inquiry ultimately leading to the administrative proceeding. Accordingly, in the absence of such evidence, the position of the Commission and the court below with respect to the subpoena question was the same as that of the Court of Appeals for the District of Columbia Circuit, which, as the court below noted, had recognized that petitioner was "obliged either to offer evidence contradicting the sworn statements of the Commission, or to point out the inadequacy and inconsistency, if any, in the sworn statements, before he was entitled to subpoena the Commission members and staff" (Pet. 13a). As the court below also pointed out (Pet. 10a), the District of Columbia Court of Appeals distinguished its earlier decision in *Amos Treat & Co.* v. *Securities and Exchange Commission*, 306 F. 2d 260, upon which the petition relies (p. 27), "on the grounds that here there was no evidence that the Commissioner sought to be disqualified had participated in an investigation of petitioner before becoming a Commissioner."

3. The petition contends that the Commission violated the Administrative Procedure Act by employing a retired examiner, serving at the Commission's pleasure, to preside over the hearing and write the recommended decision. However, petitioner's counsel has made no claim of actual prejudice resulting from the alleged irregularity, and, indeed, earlier stated "that the Hearing Examiner, under very difficult circumstances and in an atmosphere which frequently disrupted the proceedings * * * [had] acted with great patience and scrupulous fairness to all parties concerned" (R. 14191). Moreover, in view of the "independent review of the record" by the commissioners deciding the administrative proceeding, who "carefully evaluated" the evidence in the light of the entire record (Pet. 7a, 21–26a), any error in this regard would appear to be harmless. Cf. *Kerner* v. *Celebrezze*, 340 F. 2d 736, 740 (C.A. 2); *Standard Distributors* v. *Federal Trade Commission*, 211 F. 2d 7, 11–12 (C.A. 2); *D'Elia* v. *New York, New Haven and Hartford R.R.*, 338 F. 2d 701, 702 (C.A. 2), affirming 230 F. Supp. 912, 915 (D. Conn.).

The challenge concerning the hearing examiner was also untimely. As the court of appeals noted, it was not made until the hearing had proceeded for a year and a half and more than 8,000 pages of testimony had been recorded,[12] and, as the hearing examiner observed, it was "no secret" to petitioner that he was well along in life (Pet. App. 101a). Whether or not

[12] Cf. 28 U.S.C. 144, which requires that objections with respect to bias and prejudice of federal judges be filed ten days before the beginning of the term at which the proceeding is to be heard.

petitioner or its counsel knew the hearing examiner's "birthday" (Pet. 14, 25), he had known the hearing examiner since 1936 and that both had been members of the Commission staff for a number of years (Pet. App. 74b, 76b; R. 15352–15353). Accordingly, the court below was clearly correct in affirming the Commission's determination that the motion to challenge the hearing examiner's qualifications came too late (Pet. 14a; Pet. App. 24a). As stated in *United States* v. *L. A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 37:

> Simple fairness to those who are engaged in the tasks of administration, and to litigants, requires as a general rule that courts should not topple over administrative decisions unless the administrative body not only has erred but has erred against objection made at the time appropriate under its practice.[13]

Nor was there any violation. The petition assumes a basic conflict between Section 11 of the Administrative Procedure Act (which authorizes the removal of hearing examiners only after hearing and for cause) and Section 13(a) of the Civil Service Retirement Act (5 U.S.C. 2263(a)), which, referring to all government employees, states that a re-employed annuitant shall serve at the will of the employing agency. However, as the Commission properly ruled (Pet. App. 93a–105a), Congress did not intend to

[13] As noted by the court below, in *Riss & Co.* v. *United States*, 341 U.S. 907, where the motion was filed on the last day of the hearings, "the hearings lasted only seven days, and the common carrier did not learn until the last day of the hearings that the examiner was not an examiner appointed under § 11 of the A.P.A." (Pet. 15a).

deprive the government of experienced hearing examiners who have reached the age of retirement. That they serve at the agency's will certainly does not compromise the "independence" of the hearing examiner from the Commission's prosecutory staff which Section 5(c) of the Administrative Procedure Act, 5 U.S.C. 1004(c), protects, and it is far-fetched to assume—in the absence of any evidence—that it makes them vulnerable to improper pressures from the agency members.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1967.

APPENDIX

Rule 15c1–2, 17 CFR 240.15c1–2, provides:

(a) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in Section 15(c)(1) of the act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(b) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in Section 15(c)(1) of the act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(c) The scope of this rule shall not be limited by any specific definitions of the term "manipulative, deceptive, or other fraudulent device or contrivance" contained in other rules adopted pursuant to Section 15(c)(1) of the act.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 614

R. A. HOLMAN & CO., INC., *Petitioner,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

R. A. HOLMAN & CO., INC., and RICHARD A. HOLMAN, *Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONERS

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SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONERS

I.

Respondent's efforts to evade the issue of the disqualification of Hearing Examiner Swift cannot obscure the fact that, as respondent itself wrote in an unanimous opinion at an earlier point in this proceeding, this case:

> "raises a question of first impression, having government-wide implications affecting the validity

> of all proceedings presided over by retired Hearing Examiners who have been reemployed." *In the Matter of R. A. Holman & Co., Inc., et al.*, 40 SEC 1133, 1134 (1962) (Pet. App. 95a).

Respondent first asserts that petitioner "has made no claim of actual prejudice resulting from the alleged irregularity." Respondent's Brief in Opposition, p. 15. This statement is simply incorrect. The petition states that "Petitioner R. A. Holman & Co. was clearly prejudiced by being subjected to a proceeding before a disqualified Hearing Examiner." Petition for Certiorari, p. 23. This Court has held that an agency must give weight to the decision of an "impartial, experienced examiner who has observed the witnesses and lived with the case." *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 496 (1951). Such weight was given to the Hearing Examiner's recommended decision in this case. Respondent stated in its opinion:

> "The evidence adduced in these proceedings is, in a number of instances, conflicting. In reaching our findings, we have carefully evaluated such evidence in light of the entire record, including the hearing examiner's findings." (Pet. App. 7a).

If respondent means to suggest that petitioners must claim or show actual bias against them by the disqualified Hearing Examiner, or specific actions demonstrating his partiality, such a contention is untenable.[1] Participation of a disqualified Hearing Examiner invalidates a prosecutory proceeding without regard to manifestations of actual bias and prejudice

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[1] For a thorough recent discussion of this problem, concluding that such a claim or showing is unnecessary, see Berger, *Do Regulations Really Bind Regulators?*, 62 Nw.U.L.Rev. 137, 167-171 (1967).

by him. This Court said in *United States* v. *L. A. Tucker Truck Lines,* 344 U.S. 33, 38 (1952), that:

> "the defect in the examiner's appointment was an irregularity which would invalidate a resulting order if the Commission had overruled an appropriate objection made during the hearings."

It is clear that on timely demand a litigant "is entitled to an examiner chosen as the Act prescribes," without the necessity of further demonstration of the Examiner's unfitness to serve. *Id.* at 36.

Any requirement of a showing of actual prejudice or bias by a disqualified Examiner would thwart the purpose of the statutory provisions mandating independence of tenure and compensation for Hearing Examiners. These provisions are plainly preventive in nature, designed to protect litigants and the administrative process from the subtle and insidious effects on judgment that result if an adjudicative officer is dependent for his office and sustenance on the agency which appointed him.

> "Fairness, of course, requires an absence of actual bias in the trial of cases. But our system of law has always endeavored to prevent even the probability of unfairness . . . ." *Re Murchison* 349 U.S. 133, 136 (1955).[2]

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[2] If a claim or showing of actual prejudice to the defense of the case is required, petitioners need only point to a series of extraordinary procedural rulings by Hearing Examiner Swift which preceded the motion to disqualify him. For example, on April 24, 1962, Swift closed the hearing over the protests of R. A. Holman & Co. at a time when petitioner was still introducing evidence, had subpoenas outstanding, and had requested additional subpoenas. (Pet. App. 84a). Petitioner was required to resort for relief to the full Commission, which ordered the hearings to be reopened by the Hearing Examiner. It also ordered the is-

Petitioner's challenge to Hearing Examiner Swift was timely. It was made during the administrative hearings, and this Court has never required more than that to constitute a timely challenge to a disqualified Hearing Examiner. *Riss & Co.* v. *United States,* 341 U.S. 907 (1951).[3]

Respondent is in no position to claim that the challenge to the Hearing Examiner was untimely. The facts establishing Swift's disqualification were known at all times to respondent, yet remained buried in respondent's files and were never disclosed to petitioner until the motion for disqualification was made. It is still not disputed by respondent that prior to April 25, 1962, plaintiff had no knowledge of the facts that disqualified Mr. Swift as Hearing Examiner. Even if petitioner's counsel had known, or had reason to know, Swift's age at any earlier point in the proceedings, they had no way of knowing that Swift was serving at the will of respondent under temporary one-

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suance of additional subpoenas requested by R. A. Holman & Co., which had been denied by the Hearing Examiner. (Pet. App. 79a-81a). Other rulings against petitioner by the Hearing Examiner were overruled by the full Commission. (Pet. App. 75a-76a; 82a).

Respondent's quotation of a statement by petitioner's counsel that the Hearing Examiner "[had] acted with great patience and scrupulous fairness", Brief in Opposition, p. 15, is totally misleading. His statement was made in a pleading of April 7, 1961, shortly after the hearings commenced, and before any of the extraordinary procedural rulings by the Examiner referred to above were made.

[3] See Berger, *supra,* 62 Nw.U.L.Rev. at 170-176.

year appointments until they gained access to his personnel files in May, 1962.[4]

Thus all efforts by respondent to exorcise the issue of Swift's disqualification must fail. That issue is squarely presented by this case, is of transcendent importance, and should be resolved by this Court.

II.

Respondent's attempt to sidestep the issue of Commissioner Woodside's disqualification is equally unavailing.

Respondent first asserts that Woodside's withdrawal from the proceedings at the stage of final decision "cured any possible error" in his participation theretofore. Brief in Opposition, pp. 11-12. Woodside's eleventh hour withdrawal effected no such cure. His participation in the case as a member of respondent had continued for over four years: the original *ex parte* suspension of the Pearson offer took place September 16, 1960, and his statement of withdrawal was announced at the time of the oral argument before respondent on March 4, 1965.

During that time the case was repeatedly before the Commission on important issues arising during the proceedings before the Hearing Examiner. We know that Woodside participated in the issuance of the *ex parte* order initiating the proceedings, in the denial

[4] The discretionary power in an agency to select which of its Hearing Examiners it will retire and which it will successively reappoint is itself subversive of the Hearing Examiner system, since it holds out to a Hearing Examiner even before retirement the prospect that those with a satisfactory record of decision from the agency point of view will be selected for reappointment.

of the motion to disqualify the Hearing Examiner, and in the decision to deny subpoenas directed to proving his own disqualification, including his own subpoena. We cannot be sure how many rulings he participated in, because of respondent's practice of not noting the names of Commissioners joining in its rulings except in rare instances. But it is evident that Woodside was actively participating in these proceedings.

His last minute withdrawal, in an obvious effort to salvage the situation he had created, cannot remove the taint. Nor can the fact that the remaining members of respondent went on to decide the case without him dispel the impact of his participation in the proceedings. In the words of the Third Circuit:

> "The Board argues that at worst the evidence only shows that one member of the body making the adjudication was not in a position to judge impartially. We deem this answer insufficient. Litigants are entitled to an impartial tribunal whether it consists of one man or twenty and there is no way which we know of whereby the influence of one upon the others can be quantitatively measured." *Berkshire Employees Association* v. *NLRB*, 121 F.2d 235, 239 (3rd Cir. 1941).

The same rule was followed by the Sixth Circuit in holding that the disqualification of one Commissioner invalidated the order and decision of the agency even though his vote was not necessary for a majority. *American Cyanamid Co.* v. *FTC*, 363 F.2d 757, 767 (6th Cir. 1966).

Respondent also advances the novel notion that, even if Woodside was disqualified because of his participation in the investigation of R. A. Holman & Co. in relation to the Pearson offering, respondent's decision

may still be upheld on the basis of its findings as to the so-called Precise offering. Respondent's Brief in Opposition, pp. 12-13. But respondent itself elected to amend its original order to add these charges against R. A. Holman & Co. based on the Precise offering to the original proceedings. (Pet. App. 49a-61a). Having joined all these charges and allowed a disqualified Commissioner to sit on them, it is hardly in a position now to put them asunder for purposes of a salvage operation.

Furthermore, there is no suggestion in the opinion of the court below that it would have drawn any such distinction and would have affirmed the order and decision below solely on the basis of the Precise offering, had it found Woodside to be disqualified. It would have had no need to engage in the tortured process of upholding Woodside's qualification, if it believed that respondent's decision could stand even if Woodside was disqualified.

Finally, if Woodside was disqualified because of his participation in the investigation of R. A. Holman & Co. which led up to the administrative proceedings against it, it is impossible to see how his disqualification can be fragmented as respondent would now do. His disqualification arose from the danger of his having prejudged petitioner's guilt because of his connection with the prior investigation of petitioner's activities. The danger of prejudgment is in no way diminished simply because he may not have personally participated in the investigation of all the charges on which the proceedings to put petitioner out of business were eventually based. Prejudice and prejudgment may be divisible states of mind to respondent, but they certainly

were not to the framers of Section 5(c) of the APA, which provides flatly that:

> "No officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, *in that or a factually related case,* participate or advise in the decision . . . ." 5 U.S.C. § 1004(c) (emphasis supplied).

Nor are they divisible under the teaching of this Court that:

> "To perform its high function in the best way 'justice must satisfy the appearance of justice.'" *Re Murchison, supra,* 349 U.S. at 136.

Respondent asserts that the record "makes clear" that, while a member of the SEC staff, Woodside's only connection with the investigation was "a formal supervisory authority" over all activities of his division and that Woodside "had no personal knowledge of the inquiries being made." Respondent's Brief in Opposition, p. 13. The record does no such thing. It is obvious that the one person who knows whether Woodside had "personal knowledge" of the investigation of petitioner is Woodside. To this day, there has not been a single public word from Woodside stating what his personal knowledge of the investigation was. All we have ever received are statements by other people, and conclusory denials by respondent itself that Woodside had "substantial knowledge of the facts in issue," whatever that may mean. There has never been an opportunity to test even these second-hand disclaimers in an adversary proceeding, despite the clear expectation of the Court of Appeals for the District of Columbia Circuit that such a proceeding would ensue, see Petition for Certiorari, pp. 28-29.

The unfairness of the proceeding in this case is compounded by Woodside's participation in the decision to deny a subpoena for himself, by which petitioner R. A. Holman & Co. sought to make its record on the disqualification issue. It is noteworthy that respondent does not even attempt to defend its curtailment of inquiry into the facts related to Woodside's disqualification.

In the other leading cases in which the courts have dealt with similar disqualification issues, there was a personal statement by the challenged Commissioner setting forth his participation in the events leading up to the administrative proceeding and the state of his knowledge of the facts. Commissioner Cohen made such a statement in *Amos Treat Co.* v. *SEC,* 306 F.2d 260 (D.C. Cir. 1962) and Chairman Dixon did so in *American Cyanamid Co.* v. *FTC,* 363 F.2d 757, 784-87 (6th Cir. 1966).

The importance of having such a statement personally from the challenged Commissioner is self-evident. Only from such a statement can the courts perform their judicial function of determining disqualification under Section 5(c) of the APA. It is noteworthy that in the *Amos Treat* case, respondent took the same view that it does here, that the challenged Commissioner was not disqualified on the basis of his prior participation in the matter. In *American Cyanamid* Chairman Dixon took the same position. The courts disagreed when the facts were on the table.

Allowing Woodside to foreclose the inquiry by his silence and allowing conclusory denials by respondent to settle the issue puts a premium on non-disclosure. Every Commissioner challenged in the future would be encouraged to preserve silence as to his knowledge

of the facts of his own participation. This could render unenforceable the statutory prohibition of the intermingling of investigative, prosecutive, and adjudicative functions in the same individual in the same proceeding.[5]

III.

Respondent denies that the courts below in the injunction proceeding against petitioners applied a *per se* rule of fraud to the predictions of future stock price increases. In support of its contention that the courts below performed their duty of demonstrating that the predictions were without reasonable basis in fact, respondent cites one statement in the "findings" below:

> "[T]here was no basis in fact for any of these predictions." (Apps App. 408a, 422a.)[6]

This single statement is all that respondent can adduce as discussion or analysis by either of the courts below of whether there was a reasonable basis in fact for the price predictions. Its insufficiency is apparent. There is no explanation in the decisions of either of

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[5] Respondent states that the Pearson registration statement under examination in Woodside's division in 1960 was "subsequently withdrawn." Brief in Opposition, p. 5. The reason for the withdrawal was simply that Pearson was merged with Grumman Boats, Inc., and thereby strengthened its financial position. (Apps. App. 430a, Pl. Ex. 5, pp. 3-4).

[6] Like all the other findings of fact and conclusions of law made by the district court, this "finding" was proposed by respondent and rubber stamped by the district court without the change of so much as a comma. (Apps. App. 422a.)

the courts below as to why "[t]here was no basis in fact for any of these predictions."[7]

If this does not constitute the imposition of a *per se* rule in this case, it is difficult to imagine what would.[8] And as we have demonstrated, such a *per se* rule is in plain contradiction of the securities acts and their prior judicial interpretation. Petition for Certiorari, pp. 31-34.

In evident recognition that the courts below did in effect impose such a *per se* rule, respondent now attempts to uphold the injunction below on the basis of other supposed violations, apart from the predictions of price increases. Respondent's Brief in Opposition, p. 9. But this disregards petitioners' right to have their case decided under a correct rule of law. If the courts below applied an erroneous rule of law—as they plainly did with respect to the stock price predictions

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[7] It is impossible to see how the courts below could reach the conclusion without any analysis or discussion of such factors as the latest sales and earnings and the price history of the stock. "The history of prices paid in the past for stock by willing investors is one of the strongest indications of what we may expect similarly disposed investors to pay in the future, given the same or similar conditions." Plotnick & McCrane, *Fundamentals for Profit in Undervalued Stock* (1964), p. 116.

[8] The one bit of evidence respondent now points to on this issue relates to statements about increases in the market price of Pearson stock to be expected during the annual New York boat show. (Apps. App. 409a.) Even now, however, respondent makes no claim that petitioners made any false statements with respect to the history of increases in Pearson stock at the time of the boat shows. There is no dispute that the stock price had risen during all previous New York boat shows. How anyone could have been misled because he was not told that the price of the stock was slightly lower at the close of certain boat shows than at the beginning is not stated.

—it is no answer for respondent to say that they might have reached the same result on other grounds.[9]

Moreover, the other grounds relied on by respondent as justifying the injunction are trivial and insignificant, as well as invalid. For example, the district court found it to be misleading that a market letter "stated that 'working capital [of Pearson] jumped from a minus figure of $17,418 to a healthy entry in the plus column of $1,284,856,' " without stating further that this was caused by transforming a current liability of $625,000 into long-term debt. (Apps. App. 411a, 422a).

This alleged misrepresentation was not mentioned in the complaint and was only dredged up by respondent the day before the trial started, over two years after the complaint was filed. (Apps. App. 200a, 276a-277a). Furthermore, it is impossible to see how this could materially mislead potential investors. There is no dispute that the quoted statement was correct, and there is no claim of any misstatement anywhere else in the market letter. Not stating that the improvement in Pearson's working capital came from the transfer of current liabilities into long-term debt, rather than from some other source, is absolutely immaterial. Clearly, the improvement did not come from earnings, which were discussed in the market letter. (See Apps. App.

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[9] At the trial in the district court respondent pressed two principal theories of deception: (a) that failure to identify particular shares offered as having been acquired by R. A. Holman & Co., "for investment" was a material omission; and (b) that future price predictions were inherently deceptive. The Second Circuit found no basis in law to support the first of these theories and vindicated petitioners on the point. Petition for Certiorari, p. 20a. Respondent now has gone far to abandon the second theory and to fall back on minutiae.

282a). Transfer of short-term to long-term debt does improve a company's working capital.[10] What difference would it make that the improvement came this way rather than from some other source?

These are examples of the trivia which respondent now relies upon to uphold the decision below.[11] They simply represent a further effort by respondent to gloss over the clear error of law by the courts below on an important issue under the securities laws. Since a prediction of future price increase is inherent in almost every stock-buy recommendation, it is vital to the securities business to know whether a rule of *per se* illegality applies to stock price predictions.

Despite respondent's disclaimer of a connection between the two cases presented, Brief in Opposition,

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[10] In this case the short-term debt was transformed into a 10-year loan (due in 1971) at the prime interest rate and guaranteed by Grumman Aircraft Engineering Corporation (Apps. App. 181a, 430a, Pl. Ex. 5, p. 9).

[11] Similarly, respondent cites statements by a salesman to certain prospective investors about a proposed merger between Pearson and "Grumman," which supposedly did not disclose that this was "Grumman Allied" instead of its parent "Grumman Aircraft." But these would-be investors were employees of Pearson's Grumman Boat division who were well aware that Grumman Aircraft and Grumman Allied were different; they never bought any stock in reliance on these alleged misrepresentations; and one of them had been sent prior to any conversation a news clipping from the *Wall Street Journal* by the salesman stating that the stock to be exchanged was Grumman Allied. (Apps. App. 54a-60a.)

These alleged misrepresentations could not violate Section 17(a)(2) of the Securities Act of 1933 in any event, since the petitioners did not "obtain money or property" thereby, a prerequisite for statutory violation. The same is true of the alleged misstatement that the stock had not risen because of dumping of shares on the market; moreover, there was evidence of selling of large numbers of shares, accompanied by a substantial drop in the price, 15%. (Apps. App 336a-338a).

pp. 4-5, the relationship of the two is apparent. The injunction case was instituted during the stay of the administrative proceeding; respondent thwarted by court order in the administrative proceeding, resorted to the injunction suit in its pursuit of petitioners and its effort to put them out of business. In and of itself, this course of conduct by respondent represents such a departure from acceptable standards of fair dealing by an administrative agency as to justify review by this Court.

It is therefore respectfully submitted that the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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PETITION FOR REHEARING OF ORDER DENYING PETITION FOR CERTIORARI

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December 28, 1967

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

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OCTOBER TERM, 1967

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v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR CERTIORARI

Petitioners respectfully request this Court to grant rehearing of its order of December 4, 1967, denying the Petition for Writ of Certiorari, and issue a Writ of Certiorari to review the judgment of the Court of Appeals for the Second Circuit in the above-entitled cases.

REASONS FOR GRANTING REHEARING AND ISSUING THE WRIT

In petitioning for certiorari, Petitioners urged, among other things, that the administrative proceeding before the Securities and Exchange Commission was invalid under the Due Process Clause and the Administrative Procedure Act because it was conducted by a retired Hearing Examiner who was serving under a terminable-at-will appointment from the Commission. See Petition for Certiorari, pp. 19-26. The applicable statute, Section 11 of the Administrative Procedure Act, 5 U.S.C. § 1010, clearly provides that:

> "Examiners shall be removable by the agency in which they are employed only for good cause established and determined by the Civil Service Commission . . . after opportunity for hearing and upon the record thereof."
>
> * * *
>
> "Examiners shall receive compensation prescribed by the [Civil Service] Commission independently of agency recommendations . . . ."

Petitioners pointed out that the Commission itself stated in its opinion that this case:

> "raises a question of first impression, having government-wide implications affecting the validity of all proceedings presided over by retired Hearing Examiners who have been reemployed." *In the Matter of R. A. Holman & Co., Inc., et al.*, 40 SEC 1133, 1134 (1962) (Pet. App. 95a).

In conformity with Rule 58(2) of the Rules of this Court, this Petition for Rehearing presents a substantial ground in support of the Petition not previously presented. Petitioners wish to bring to this Court's

attention, as was not done in the original Petition, the magnitude of the implications of this question for administrative proceedings throughout the federal government.

We are advised that, according to the records of the Civil Service Commission, there are approximately six reemployed annuitants presently serving as Hearing Examiners and there are over 550 Hearing Examiners in the various federal agencies.

Each of these persons is potentially affected by the question raised in this case. The legal right of the reemployed annuitants to continue to sit in proceedings governed by the Administrative Procedure Act will be left unsettled if this Court does not review this case. Challenges to their qualifications in future proceedings are to be anticipated, since the question is too important to go undecided.

As a result, a cloud will hang over all proceedings conducted by reemployed annuitants until it is dispelled by the Court one way or the other. It is therefore critical for this question to be resolved. This case provides an appropriate occasion for this Court to do so. We are presenting only a straightforward question of law: was the Hearing Examiner disqualified by reason of his lack of independence of tenure and compensation from the agency which appointed him?

Moreover, the more than 550 Hearing Examiners who have not yet reached retirement age are also directly affected, as is the conduct of administrative proceedings over which they preside. A number of these are approaching the age of retirement. Whether a Hearing Examiner may be appointed at the discre-

tion of an agency to preside after his retirement may significantly influence Hearing Examiners who are concerned about their financial status upon retirement. In this case, reappointment meant a difference of almost $10,000 a year to the reemployed annuitant.

The potential effect on a Hearing Examiner's judgment resulting from a discretionary power in an agency to reappoint annuitants is obvious: an Examiner concerned with his economic security in old age may be tempted to decide the agency's way during his active service in order to enhance his chances of reappointment after retirement.

As this Court said in *Tumey* v. *Ohio,* 273 U.S. 510, 532 (1929):

> "Every procedure which would offer a possible temptation to the average man as a judge to forget the burden of proof required to convict the defendant, or which might lead him not to hold the balance nice, clear and true between the state and the accused denies the latter due process of law."

The Hearing Examiner system was created to guarantee independent adjudication in administrative proceedings, an indispensable element of due process, particularly in a prosecutory proceeding like the present which has resulted in the destruction of a valuable going business. The practice of reemploying annuitants is compromising the integrity of the Hearing Examiner system and is subversive of the administrative process.

Too many individuals and too many administrative proceedings are affected by the decision of this question for this Court to leave it in limbo. We submit that a question of such importance should be reviewed by this Court.

CONCLUSION

For the reasons discussed in the Petition for Certiorari and in this Petition for Rehearing, it is respectfully requested that rehearing be granted and that, upon such rehearing, a Writ of Certiorari issue to the Court of Appeals for the Second Circuit.

Respectfully submitted,

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December 28, 1967

Certificate of Counsel

I, DANIEL A. REZNECK, an attorney for Petitioners, hereby certify that the foregoing Petition for Rehearing is presented in good faith and not for delay and that the Petition is restricted to the grounds specified in Rule 58 of the rules of this Court.

DANIEL A. REZNECK
Counsel for Petitioners